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2024 RELEASE

Principles of Auditing & OTHER ASSURANCE SERVICES



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Principles of Auditing & Other Assurance Services

2024 Release

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PRINCIPLES OF AUDITING & OTHER ASSURANCE SERVICES

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1 2 3 4 5 6 7 8 9 LWI 29 28 27 26 25 24

ISBN 978-1-266-85766-9

MHID 1-266-85766-4

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Preface

The 2024 Release of *Principles of Auditing & Other Assurance Services* provides a carefully balanced presentation of auditing theory and practice. Written in a clear and understandable manner, it is particularly appropriate for students who have had limited or no audit experience. The approach is to integrate auditing material with that of previous accounting financial, managerial, and systems courses.

The text's first nine chapters emphasize the philosophy and environment of the auditing profession, with special attention paid to the nature and economic purpose of auditing, auditing standards, professional conduct, legal liability, audit evidence, audit planning, consideration of internal control, and audit sampling. Chapters 10 through 16 (the "procedural chapters") deal with internal control and obtaining evidence about the various financial statement accounts and classes of transactions, emphasizing a risk-based approach to selecting appropriate auditing procedures. Chapter 17 presents the auditors' reporting responsibilities when performing financial statement audits. Chapter 18 provides detailed guidance on integrated audits of public companies performed in accordance with PCAOB and SEC requirements under the Sarbanes-Oxley Act of 2002. Chapters 19 and 20 present the auditors' reporting responsibilities when performing other attestation and accounting services, such as reviews and compilations of financial statements and performing services on prospective financial statements. Chapter 21 presents coverage of internal, compliance, and operational auditing.

The text is well suited for an introductory one-semester or one-quarter auditing course. Alternatively, it is appropriate for a two-course auditing sequence that covers the material in greater detail. For example, an introductory course might emphasize Chapters 1 through 10, 16, and 17. A second course may include coverage of the other procedural chapters (Chapters 11 through 15); integrated audits (Chapter 18); other attestation and accounting services; and internal, operational, and compliance auditing (Chapters 19, 20, and 21). With two courses, the instructor might wish to consider covering portions of Chapter 9 on sampling in the second course, with or without audit software. Overall, the text and supporting materials provide:

1. **A balanced presentation.** The text provides a carefully balanced presentation of auditing and assurance theory and practice. The concepts are written in a clear, concise, and understandable manner. Real company examples are integrated throughout the text to bring this material to life. Finally, Keystone Computers & Networks Inc., the text's illustrative audit case, is integrated into selected chapters, providing students with hands-on audit experience.
2. **Organization around balance sheet accounts emphasized in previous accounting courses.** Organizing the text around balance sheet accounts is a particularly straightforward and user-friendly way to address the risk assessment-based approach to auditing required by both U.S. and international auditing standards. These standards require an in-depth understanding of the audited company and its environment, a rigorous assessment of the risks of where and how the financial statements could be materially misstated, and an improved linkage between the auditors' assessed risks and the particulars of audit procedures performed in response to those risks. Chapters 5 through 7 of the text describe the risk assessment approach in detail. Chapters 10 through 16 are aligned with the risk assessment approach presented in the professional standards. Accordingly, the suggested audit approach and procedures of the professional standards flow smoothly from the approach suggested in earlier chapters of the text. In short, our organization of the book facilitates student learning of the risk assessment process in a very straightforward manner. Also, although the text chapters are structured around balance sheet accounts, they thoroughly cover the various transaction cycles. For example, Chapter 11 provides detailed coverage of the revenue cycle.

3. **A cohesive connection from learning to career: Data analytics** skills are a rapidly expanding requirement in the field of auditing. To prepare students, data analytics is addressed in Appendix 6A and throughout this text, incorporating exercises and problems that drive critical thinking and analysis. In conjunction, we incorporate software to drive these employability skills through the use of Excel, Tableau, and IDEA software and with data analytics questions posed in Connect.
4. **CPA examination support.** The text's emphasis on current auditing standards, its many author-created objective questions (including document review simulations), and a partnership with UWorld CPA Review are all aimed at helping students pass the CPA exam. As discussed in detail in the following sections, this release has been revised to respond to changes in the CPA exam and includes a variety of simulations like the ones included on the CPA exam, with several now included in Connect.
5. **Strong student and instructor support.** Connect and its vast array of instructor and student resources provide a wealth of material to help keep students up-to-date.

We are confident that the 2024 Release of *Principles of Auditing & Other Assurance Services* will provide students with a clear perspective of today's auditing environment.

O. Ray Whittington
Kurt Pany

Key Features of the Book

The first seven chapters of the text emphasize the philosophy and environment of the profession, with special attention paid to the nature and economic purpose of auditing and assurance services, professional standards, professional conduct, legal liability, audit evidence, audit planning, and consideration of internal control.

Chapter 1: Emphasizes the role of the public accountant, the structure of CPA firms, and the various types of audits and auditors. It also introduces the important concept of corporate and includes a brief history of the auditing profession, including up-to-date of the Sarbanes-Oxley Act of 2002 and the Public Company Accounting Oversight Board.

Chapter 2: Includes detailed coverage of the various professional standards underlying audits and other attestation services. Coverage of engagement quality reviews and inspections has been expanded. Also included are up-to-date introductory overviews of both public company and nonpublic company audit reports.

Chapter 3: Updated to reflect the most recent AICPA and PCAOB requirements. This includes detailed coverage of the AICPA Code of Professional Conduct and research-oriented questions. Problems requiring an electronic search of the AICPA Code of Professional Conduct are included. Updated coverage includes responsibilities related to unpaid professional fees, independence when consulting on information systems services, and responsibilities related to a client's noncompliance with laws and regulations.

Chapter 4: Clear, concise coverage of CPA legal liability reviewed by legal scholar Professor Marianne Jennings of Arizona State University.

Chapters 5, 6, and 7: Material from the risk assessment standards is thoroughly integrated throughout.

Chapter 5: Includes a broad discussion of the nature of audit evidence, reflecting up-to-date coverage of both AICPA and PCAOB pronouncements. Updated coverage of data analytics as applied to auditing is also included.

Chapter 6: The risk assessment approach as applied to the audit process is concisely summarized. This chapter also includes a detailed discussion of the materiality concept and the audit of significant unusual transactions and significant risks.

Chapter 7: Discusses internal control and how it is considered in an audit of financial statements. The chapter includes a brief overview of the nature of an integrated audit (an audit of internal control integrated with an audit of the financial statements) required for certain public companies under PCAOB Auditing Standards, with more detailed coverage provided in Chapter 18. The chapter also includes a section on the audit requirements for that increasingly frequent situation in which a client outsources its data processing to a service organization. Finally, it presents the auditors' internal control communication responsibilities.

Audit Standards Updates Students in auditing need familiarity with auditing standards promulgated by the **AICPA's Auditing Standards Board and the Public Company Accounting Oversight Board**. Also, for many, familiarity with standards of the **International Auditing and Assurance Standards Board** is needed. While similar in most respects, key differences exist among these sets of standards. The text integrates discussions of the various standards, focusing on the differences, in a very readable manner.

CPA Exam Prep and Simulations The end-of-chapter exercises include a number of simulations similar to those on the **CPA exam**. These simulations include five document review simulations which are all related to the text's integrated case, **Keystone Computers & Networks Inc.** All simulations in the text are designed to help students both to learn the material presented and to prepare them to complete such questions on the **CPA Exam**. Many of the simulations are adapted from **CPA exam questions** released by the **AICPA**, and others were written by the authors to be similar to those released by the **AICPA**.

Data Analytics and Auditing Increasingly, collection of audit evidence is facilitated by the use of automated tools and techniques such as **Audit Data Analytics** that may enable auditors to aggregate and consider information obtained from multiple sources. Accordingly, the text has been revised to emphasize developments in this area.

- 1 The Role of the Public Accountant in the American Economy
- 2 Professional Standards
- 3 Professional Ethics
- 4 Legal Liability of CPAs
- 5 Audit Evidence and Documentation
- 6 Audit Planning, Understanding the Client, Assessing Risks, and Responding

Keystone Computers & Network Inc.: Illustrative Audit Case This feature has been updated in this release and illustrates audit methods and provides realistic, thought-provoking case exercises. Although each portion of the case is designed to stand alone, if used in combination, the case will help the student develop problemsolving skills in planning (Chapter 6), in considering internal control and testing account balances (Chapters 11 and 14), and in completing the audit (Chapter 16). The case incorporates the use of computerized accounting applications (both IDEA and Tableau) and also integrates the fundamentals of audit sampling from Chapter 9. Also, Document Review Simulations relating to Keystone are included in the problem material for Chapters 10, 11, 12, 14, and 17.

- 7** Internal Control
- 8** Consideration of Internal Control in an Information Technology Environment
- 9** Audit Sampling
- 10** Cash and Financial Investments
- 11** Accounts Receivable, Notes Receivable, and Revenue
- 12** Inventories and Cost of Goods Sold
- 13** Property, Plant, and Equipment: Depreciation and Depletion
- 14** Accounts Payable and Other Liabilities
- 15** Debt and Equity Capital
- 16** Auditing Operations and Completing the Audit
- 17** Auditors' Reports
- 18** Integrated Audits of Public Companies
- 19** Additional Assurance Services: Historical Financial Information
- 20** Additional Assurance Services: Other Information
- 21** Internal, Operational, and Compliance Auditing

Chapter 8: Emphasizes the impact of IT on audits. This chapter has been updated and continues to emphasize the suggestions by George Easton, PhD, Emeritus Professor of MIS, San Diego State University.

Chapter 9: The format of this chapter allows adopters flexibility in audit sampling coverage. The body of the chapter includes attributes sampling and an introduction of audit sampling for substantive tests. Following are stand-alone modules on (1) monetary unit sampling, (2) classical variables sampling, and (3) nonstatistical variable sampling. Any, all, or none of these modules may be selected for inclusion. The chapter concludes with the longstanding appendix on the audit risk model. Many of the problems may be solved either manually or electronically using Connect and generalized audit software.

Chapters 10 through 16: These “procedural chapters” deal with internal control and obtaining audit evidence for the various financial amounts. The chapters emphasize the risk-based approach stressed in AICPA, PCAOB, and international standards. Updated in these chapters are discussions of data analytical evidence-gathering techniques, and increased coverage of management review controls, which is an area of concern from PCAOB inspections.

Chapter 17: Provides both AICPA and PCAOB audit reporting requirements. It is designed to easily allow a comparison of those requirements (e.g., a comparison of key and critical audit matters).

Chapter 18: Reflects PCAOB auditing standards on the audit of internal control over financial reporting required as a part of integrated audits for public companies.

Chapter 19: Includes up-to-date coverage of financial statement preparation, compilation and review engagements, auditor reporting on statements prepared using a special purpose framework, and other changes due to the AICPA clarity standards.

Chapter 20: Discusses a variety of attestation and other assurance services. Detailed coverage is included on Trust Services and System and Organization Controls reports. Other assurance services are included at both the conceptual and practical levels.

Chapter 21: Includes a discussion of compliance auditing based on the suggestions of Mr. Norwood J. Jackson, former Deputy Controller, Office of Federal Management, U.S. Office of Management and Budget. It is updated for the Compliance Supplement as revised in 2019.

New to This Release

The 2024 Release has been revised to reflect the changes occurring in the accounting profession and in the CPA exam, as well as to generally update and improve the presentation of material, including

- **Reflecting Changes Related to the CPA Evolution Initiative (Initiative).** This Initiative is a joint effort of the American Institute of Certified Public Accountants (AICPA) and the National Association of State Boards of Accountancy (NASBA) to transform the CPA licensure model to recognize the rapidly changing skills and competencies accountants need today and will need in the future. The Initiative has led to changes that will be reflected both in academic accounting programs and in the CPA exam, including
 - A Proposed CPA Evolution Model Curriculum.
 - Modification of the CPA Exam effective in 2024.

The revision reflects author consideration of the completeness and adequacy of text audit coverage when compared to the Model Curriculum and the modified CPA Exam. Illustrations are described below.

- **“Ordinary” Revisions to Reflect Changes in Professional Standards and to Clarify Overall Presentation.** As with every release, professional standards changes are reflected as appropriate, and existing material is clarified.
- **Further Consideration of Single- or Multiple-Course Adoption.** While the text has long been used by some schools in both first and second auditing courses, its wide variety of topical coverage makes it particularly appropriate for such courses designed considering the Model Curriculum and the revised CPA Exam. Revisions have been made with the following consideration in mind; the text should be appropriate either for single- or multiple-course adoption.

More specific illustrations of 2024 Release text modifications include the following:

- **Description of the CPA Exam Format Change.** Chapter 1 describes the nature of changes made to the CPA Exam. Briefly, the exam consists of three required Core sections and one individually selected Discipline section. The three required Core sections are (1) Auditing and Attestation, (2) Financial Accounting and Reporting, and (3) Taxation and Regulation. The three Discipline sections, of which exam-takers select one, are (1) Business Analysis and Reporting, (2) Information Systems and Controls, and (3) Tax Compliance and Planning. Detailed content areas, particularly for auditing and attestation, are included throughout the text.
- **Risk Assessment.** AICPA Auditing Standards Board *Statement on Auditing Standards No. 145: Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* provides CPAs with additional guidance on assessing the risks of material misstatement on an audit. While this broad standard affects many areas of the professional standards and the text, Chapters 5, 6, and 7 include helpful concepts from the standard to aid students in understanding the approach to be taken on audits. Additional guidance is provided, primarily in the procedural chapters (Chapters 10 through 16) as appropriate.
- **System and Organization Controls (SOC) Reports.** SOC coverage is expanded in Chapters 7, 16, and 20. Chapter 7 particularly emphasizes SOC 1 reports since they are often used in conjunction with audits of financial statements when outsourcing is involved. Chapter 7 also briefly introduces SOC 2 and SOC 3 reports on a service organization’s controls using one or more of the trust services criteria developed by the public accounting profession. Chapter 16 briefly describes SOC reporting from the perspective of service providers. As in the past, Chapter 20 emphasizes SOC 2 and SOC 3 reporting and also introduces SOC for Cybersecurity and Supply Chain. All three chapters now use outsourcing of payroll as an illustration.
- **Government-Related Audits.** Chapter 2 now introduces (1) audits in accordance with *Generally Accepted Government Auditing Standards*, (2) audits in accordance with the Single Audit Act, and (3) audits of employee benefit plans subject to the Employee Retirement Income Security Act of 1974. While recognizing that many audits are mandated or otherwise related to the government requirements, the text informally refers to these as “Government Related Audits” in Chapter 2. Some coverage of these audits may be expected on the CPA Exam. More detailed coverage on these audits is updated and expanded in Chapter 19, a chapter often covered in an advanced auditing course.

- **Quality Management (Control) Standards.** Chapter 2's section on quality control standards is revised to cover the recent pronouncement of the AICPA Auditing Standards Board, which was modeled after the International Auditing and Assurance Services Standards Board quality management standards.
- **Increased Coverage of Inspections and Reviews.** The text's coverage of inspections and reviews has been expanded in Chapter 2 to now include more guidance on engagement quality reviews and inspections.
- **Concept Overview Videos.** New supplemental videos have been added with this release. The videos highlight particularly important, key information in each chapter. They are designed to be used in a variety of ways, including early in the discussion of a chapter or near completion of study of that chapter. Comments on them from both students and instructors have been very positive. Additional changes include:
 - **Enhanced Coverage of Excel.** The text has long incorporated exercises that may be solved using Microsoft Excel. Enhanced coverage in this edition results in exercises included in McGrawHill's Integrated Excel Tool. The unit of exercises includes using Excel for analytical procedures, sampling, and evaluating audit findings.
 - **Enhanced PCAOB General Coverage.** While coverage of PCAOB standards is emphasized throughout the text, Chapter 1 includes background coverage that has been thoroughly updated.
 - **AICPA Code of Professional Conduct Updates.** The text includes a number of updates to the Code of Professional Conduct made by the AICPA's Professional Ethics Executive Committee. Key updates relate to
 - unpaid professional fees,
 - independence when consulting on information systems services, including the implementation of accounting standards,
 - responsibilities related to a client's noncompliance with laws and regulations, and
 - continuing education integrity of accountants related to ethical responsibilities.
 - **Remote Auditing.** Chapter 6 includes a discussion of remote auditing and Chapter 7 has an Illustrative Case on the need to consider changes in internal control when the client's system has changed to include employees working remotely.
 - **Cryptoassets.** Chapter 13 includes audit considerations involved when a client holds or transacts using cryptoassets.
 - **Group Financial Statements.** These financial statements, also referred to as consolidated financial statements, are those that include the financial information of more than one entity or business unit prepared through a consolidation process. Chapter 17 is updated to include AICPA and PCAOB changes in auditor reporting and performance requirements when more than one CPA firm is involved with the group audit.



UWorld CPA Review content is integrated directly into your Connect course and provides the highest quality CPA Exam multiple-choice questions, helping students master key concepts they will see on the CPA Exam. In addition to access throughout Connect, UWorld provides a wide variety of options for you to integrate their entire suite of CPA Review resources directly into your program. To learn more, visit: <https://accounting.uworld.com/cpa-review/partner/university/>.

Text Features

Illustrative Cases

Actual business and accounting examples are used to illustrate key chapter concepts. The cases are boxed and appear throughout the text. They are subtitled for easy reference.

	Illustrative Case	Indirect Financial Interests
	A covered member who owns shares in a mutual fund has a direct financial interest in the mutual fund, and an indirect financial interest in the mutual fund's investments. Thus, a covered member could not be involved in the audit of the mutual fund itself due to the direct financial interest. Concerning the mutual fund's investments in companies potentially audited by the covered member's firm, the following apply: 1. Ownership of 5% or more of the outstanding shares	The following illustrates how to evaluate whether the underlying investment is material to a <i>covered member's</i> net worth. Assume: • Jano Mutual Fund, a diversified fund, has net assets of \$10 million, composed of an investment in shares of client Apple and a variety of other investments. • The <i>covered member</i> owns 6 percent of the outstanding shares of Jano Mutual Fund (a value of \$600,000). • Jano Mutual Fund has 2 percent of its assets invested in Apple (a \$200,000 investment).

Industry Focus Cases

These cases use examples from specific industries to provide students with a detailed, “real-world” illustration of points being emphasized in the text. These cases show the importance of having a thorough knowledge of the audit client’s business and industry. Like the Illustrative Cases, these cases are boxed and appear throughout the text.

Focus on the Airline Industry
Electronic ticketing, basic to the airline industry, allows a passenger to electronically book a flight using any of a variety of devices and to be assigned a reservation number rather than being issued a physical ticket. Because no ticket is created for the flight, auditors are limited in the extent to which they can examine “paper” support for transactions. Accordingly, audit procedures should be developed relating to the associated revenues and receivables. Auditors often choose to include tests of the computer controls in such situations.

Auditing Fair Value Information

As the accounting profession continues to value more assets and liabilities at their fair values, difficult audit issues often arise. The text includes integrated coverage of fair value accounting in Chapters 5, 10, 11, 13, and 16.

Audit Objectives

The use of Audit Objectives is a basic tool in audit plan design. These help the auditor focus on the *reason* a procedure is being done and provide a check to assure that all management assertions in the financial statements are audited.

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Rights	☒

3. Inspect Notes on Hand and Confirm Those with Holders.

The inspection of notes receivable on hand should be performed concurrently with the count of cash and securities to prevent the concealment of a shortage by substitution of cash for misappropriated negotiable instruments, or vice versa. Any securities held by the client as collateral for notes receivable should be inspected and listed at the same time. The auditors should maintain complete control over all negotiable instruments until the count and inspection are completed.

Fraud

Because fraud is such an important aspect of today's auditing environment, we have included a logo wherever we talk about its implications in the auditing process.

Errors and Fraud



Auditing standards define **errors** as unintentional misstatements or omissions of amounts or disclosures in the financial statements. Errors may involve mistakes in gathering or processing data, unreasonable accounting estimates arising from overlooked or misinterpreted information, or mistakes in the application of applicable accounting principles.

Fraud, as the term is used in financial statement auditing (AICPA AU-C 240; PCAOB AS 2401), relates to *intentional* acts that cause a misstatement of the financial statements. Misstatements due to fraud may occur due to either (1) fraudulent financial reporting or (2) misappropriation of assets.

During the planning stage of an audit, the auditors are required to assess the risk of material

END-OF-CHAPTER MATERIAL

The material at the end of each chapter includes a combination of Review Questions, Questions Requiring Analysis, Objective Questions, Problems, In-Class Team Cases, Research and Discussion Cases, and/or Ethics Cases. Appendixes to Chapters 6, 11, and 14 include the case material and exercises for the Keystone Computers & Networks Inc., the illustrative audit case. Many of these questions are included in Connect as well. Manually graded Questions Requiring Analysis, algorithmic versions of select Objective Questions, auto-graded simulations, and Completion Questions located within the Additional Study Questions are also available in Connect.

Review Questions

The Review Questions are closely related to the material in the chapter and provide a convenient means of determining whether students have grasped the major concepts and details contained in that chapter.

Questions Requiring Analysis

The Questions Requiring Analysis require thoughtful consideration of a realistic auditing situation and the application of professional standards. A number of these questions are taken from CPA and CIA examinations, and others describe actual practice situations. These questions, which are generally shorter than the problems, tend to stress value judgments and conflicting opinions. They are now available for Connect assignment with manual grading.

Objective Questions

The Objective Questions are similar in format to those on the CPA exam. The first Objective Question in each chapter is composed of at least 12 multiple choice questions. Following that question are a number of task-based and document review simulations (discussed in the next section) and other objective questions. As indicated previously, the task-based simulations are from two sources—AICPA released questions (as adapted) and questions developed by the authors. All of the task-based simulations are meant to provide students with both learning experience relating to the material in the chapter and a realistic example of CPA exam testing. The other objective questions address basic concepts and information covered by AICPA simulations but may be less complete or may address a more limited content area than is typically the subject of an AICPA simulation.

Document Review Simulations

A document review simulation presents a realistic document as well as related source materials requiring candidate review. These simulations ordinarily include highlighted words, phrases, or sentences in the document that may or may not be correct, requiring the candidate to select appropriate edits based on the relevant source documents. We have written a number of such simulations and included them in the text's integrated case, **Keystone Computers & Networks Inc.**, in Chapters 10, 11, 12, 14, and 17. These simulations are available for assignment within McGraw-Hill's online homework management system, Connect.

Problems

Many of the Problems are drawn from CPA and CIA examinations. These problems are retained because they require a relatively detailed analysis of audit situations. Problems are keyed to the chapter's Learning Objectives.

In-Class Team Cases

These cases are meant to be solved in class either by teams of students or, if the instructor prefers, by individuals. They help provide the student with an active learning environment in which to apply key concepts included in each chapter.

In-Class Team Case



LO 2-3 2-43. Hide-It (HI), a family-owned business based in Tombstone, Arizona, builds custom homes with special features, such as hidden rooms and hidden wall safes. Hide-It has been an audit client for three years. You are about to sign off on a "clean" unmodified opinion on HI's current annual financial statements when Art Hyde, the VP-Finance, calls to tell you that the Arizona Department of Revenue has seized control of a Hide-It bank account that includes about \$450,000 of company funds; the account is not currently recorded in the accounting system and you had been unaware of it. In response to your questions about the origin of the funds, Art assures you that the funds, though not recorded as revenue, had been obtained legitimately. He explains that all of the money came from separately billed but unrecorded change orders to

Research and Discussion Cases

These cases involve controversial situations that do not lend themselves clear-cut answers. Students are required to research appropriate professional literature and then apply critical thinking skills to logically formulate and justify their personal positions on the issues involved in each case. The cases acquaint students with the professional literature, develop research and communication skills required on the new CPA exam, and demonstrate that several diverse, yet defensible, positions may be argued persuasively in a given situation.

relating to its maintenance. Otherwise, the two are self-supporting. Scott is a stockbroker, and recently she has started acquiring shares in one of the audit clients of this office of the public accounting firm. The shares are held in Scott's name. At present, the shares are not material in relation to her net worth.

Case 2: Mary Reed, a new staff auditor with the firm, has recently separated from her husband. Mary has filed for divorce, but the divorce cannot become final for at least five months. The property settlement is being bitterly contested. Mary's husband has always resented her professional career and has just used community property to acquire one share of common

Ethics Cases

Ethics Cases allow the instructor to discuss ethical issues in an integrated manner throughout the course. The cases present a series of situations that result in ethical dilemmas of the type that beginning accountants may expect to encounter in practice. These cases are included in selected chapters.

Ethics Cases

LO 11-1, 2, 6



11-51. You are an assistant audit or with Zaird & Associates, CPAs. Universal Air (UA), your fifth audit client in your eight months with Zaird, is a national airline based in your hometown. UA has continued to grow while remaining healthy financially over the eight years of its existence. Indeed, as you start the audit, you notice that (unaudited) sales are up 30 percent this year (20X1), with earnings up 40 percent. Your firm, Zaird & Associates, has been UA's only auditor.

During the audit you noticed that UA records sales when tickets are sold—debit receivable (or cash), credit sales. In performing substantive procedures relating to receivables, you also found that some of the "tickets" are for 20X2 flights—generally in January and early February.

Illustrative Audit Case Exercises

These exercises all pertain to the text's updated continuing integrated case, **Keystone Computers & Networks Inc.** While each exercise may “stand alone,” when used combination, these case exercises take the student from the original planning of an audit through the testing of controls, substantive testing, and accumulation and analysis of uncorrected misstatements. Exercises are included in Chapters 6, 11, 14, and 16. Also, the text's document review simulations relate to this integrated case—in Chapters 10, 11, 12, 14, and 17.

Appendix 6C

Illustrative Audit Case: Keystone Computers & Networks Inc.

Part I: Audit Planning

The Keystone Computers & Networks Inc. (KCN) case is used throughout the text to illustrate audit procedures and methodology. KCN is a company that sells and installs computer workstations and networking software to business customers. The CPA firm of Adams, Barnes & Co. audited the financial statements of the past three

Spreadsheet Templates

Spreadsheet templates are available on the text's website to be used in conjunction with selected audit case exercises. The exercises with templates are identified by a logo in the margin.

LO 6-3, 4

6C-4. The working paper for Keystone Computers & Networks' analytical review ratios is presented in this appendix.



- Recalculate the 12/31/X5 ratios using Excel.
- After completing part (a), review the ratios and identify financial statement accounts that should be investigated because the related ratios are not comparable to prior-year ratios, industry averages, or your knowledge of the company.
- For each account identified in part (b), list potential reasons for the unexpected account balances and related ratios.

Internet Assignments

Internet assignments are included among the end-of-chapter problem material for selected chapters. These assignments require students to use the **Internet** to do audit research and are identified with a logo in the margin.

LO 6-3



6-50

Perform an Internet search to access the text of the Securities Exchange Act of 1934. Read and summarize the internal control requirements of Section 13(b)(2) of the act.

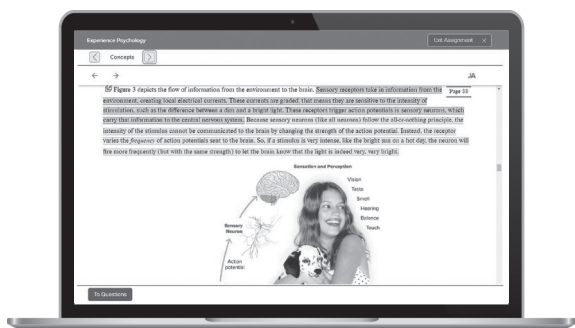
Audit Software Assignments

The text's generalized audit software materials using IDEA and Tableau are included in the Instructor and Student Resources within Connect Library. The IDEA materials are composed of two stand-alone modules—(1) audit sampling and (2) overall analytics skills coverage—that integrate analytics into text and course coverage. Either or both of these modules may be incorporated into the course to supplement traditional coverage. The Tableau materials are included in one module that takes the user from the very basic essentials of Tableau through detailed exercises using textual materials. Also, Chapter 9 identifies problems for use with generalized audit software.

A complete course platform

Connect enables you to build deeper connections with your students through cohesive digital content and tools, creating engaging learning experiences. We are committed to providing you with the right resources and tools to support all your students along their personal learning journeys.

65%
Less Time
Grading



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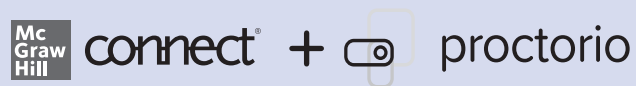


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Acknowledgments

The work of Donald A. Schwartz, JD, CPA, of National University, in developing the software supplement for the illustrative audit case exercises is especially appreciated. We thank Norwood Jackson (formerly of the U.S. Office of Management and Budget) for his guidance on compliance auditing.

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DePaul University
Jeffrey J. Archambault
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Barbara Arel
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The Role of the Public Accountant in the American Economy

LO 1-1

Describe the nature of assurance services.

Dependable information is essential to the very existence of our society. The investor making a decision to buy or sell securities, the banker deciding whether to approve a loan, the government in obtaining revenue based on income tax returns—all are relying upon information provided by others. In many of these situations, the goals of the providers of information may run somewhat counter to those of the users of the information. Implicit in this line of reasoning is recognition of the social need for independent public accountants—individuals of professional competence and integrity who can tell us whether the information that we use constitutes a fair picture of what is really going on.

Our primary purpose in this chapter is to make clear the nature of independent audits and the accounting profession. We begin with a discussion of the broader concept of assurance services. Next, we describe those assurance services that involve attestation, of which audits of financial statements are an important type. Another purpose of this chapter is to summarize the influence exerted on the public accounting profession by the American Institute of Certified Public Accountants (AICPA), the Financial Accounting Standards Board (FASB), the Governmental Accounting Standards Board (GASB), the Federal Accounting Standards Advisory Board (FASAB), the Public Company Accounting Oversight Board (PCAOB), the Securities and Exchange Commission (SEC), and the International Federation of Accountants (IFAC). We also will explore various types of audits and note the impact of The Institute of Internal Auditors (IIA) and the Government Accountability Office (GAO). Finally, we will examine other types of professional services and the nature and organization of public accounting firms.

What Are Assurance Services?

The name **assurance services** is used to describe the broad range of information enhancement services performed by a certified public accountant (CPA) that are designed to enhance the credibility or usefulness of the information. In general, assurance services consist of two types: those that increase the reliability of information and those that involve putting information in a form or context that facilitates decision making. In this chapter, we will focus on the first type—audit and assurance services that involve reliability enhancement.

Attest Engagements

LO 1-2

Identify assurance services that involve attestation.

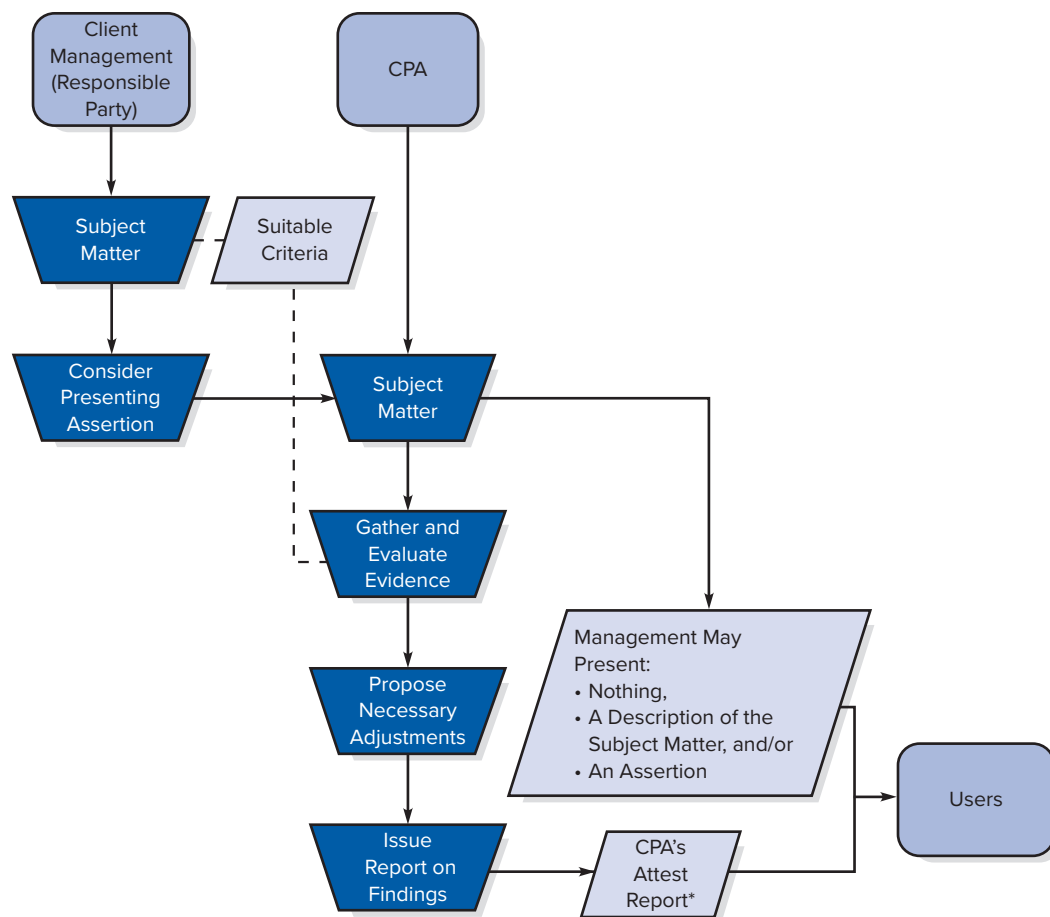
A significant portion of the assurance services provided by CPAs is referred to as *attestation services*. To attest to information means to provide assurance as to its reliability. In an **attestation engagement** (also referred to as an attest engagement), CPAs provide a report on subject matter or an assertion about that subject matter.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 1-1** Describe the nature of assurance services.
- LO 1-2** Identify assurance services that involve attestation.
- LO 1-3** Describe the nature of financial statement audits.
- LO 1-4** Explain why audits are demanded by society.
- LO 1-5** Describe how the credibility of the accounting profession was affected by the large number of companies reporting accounting irregularities in the beginning of this century.
- LO 1-6** Contrast the various types of audits and types of auditors.
- LO 1-7** Explain the regulatory process for auditors of public companies and auditors of nonpublic companies.
- LO 1-8** Describe how public accounting firms are typically organized and the responsibilities of auditors at the various levels in the organization.

FIGURE 1.1
The Attest Function



*If the criteria are not generally available to the users, they should be presented in the CPA's report or management's presentation.

CPAs attest to many types of subject matter (or assertions about subject matter), including financial forecasts, internal control, compliance with laws and regulations, and advertising claims.

Figure 1.1 describes the attest function, which begins with the subject matter that is the responsibility of another party, usually management. As an example, consider the situation in which the CPAs attest to a company's compliance with a state's laws and regulations on employee health requirements. The CPAs may be engaged to report directly on compliance with the specific requirements of the laws and regulations (the subject matter). Alternatively, they may report on an *assertion made by management* that the company complied with the laws and regulations. In this second case, the attestation report would include an opinion on whether management's **assertion** is materially correct. This type of audit is discussed in Chapter 20.

What presentation standards should the subject matter follow? The standards for presentation generally are those established or developed by groups composed of experts and are referred to as **suitable criteria**. In a compliance engagement such as the above, the criteria would address what is meant by substantial compliance with the law's specific requirements. In a financial statement audit, another term arises to describe suitable criteria—**financial reporting framework**. The suitable criteria in a financial statement audit are set forth in the financial reporting framework selected by management, in the United States usually **generally accepted accounting principles (GAAP)**. The CPAs perform a financial statement audit to gather sufficient evidence to issue an audit report that includes their opinion on whether the financial statements (the subject matter) follow the **applicable financial reporting framework** (i.e., the financial reporting framework chosen by management).



Illustrative Case

The Value of Attest Services

CPAs have attested that a supermarket chain in Phoenix has the lowest overall prices in that city. The CPAs selected a sample of approximately 1,000 items and compared the prices to those of the various

other major supermarkets. Representatives of the supermarket chain stated that the credibility added by the CPAs has helped to convince consumers that the chain's prices are indeed the lowest.

The three types of attest engagements are examinations, reviews, and the performance of agreed-upon procedures. An **examination**, referred to as an *audit* when it involves historical financial statements, provides the highest form of assurance that CPAs can offer. In an examination, the CPAs select from all available evidence a combination that limits to an acceptably *low level* the risk of undetected material misstatement allowing the CPA to express *reasonable assurance* that the subject matter (or assertion) is materially correct. A **review** is substantially less in scope of procedures than an examination and is designed to lend limited assurance that the information is materially correct. If an examination or review does not meet the client's needs, the CPAs and specified users of the information may mutually decide on specific agreed-upon procedures that the CPAs will perform. An **agreed-upon procedures engagement** results in a report by the CPAs that describes those procedures and their findings. Chapter 19 discusses the requirements of agreed-upon procedures engagements. Figure 1.2 summarizes the forms of attestation engagements.

Assurance and Nonassurance Services

It is important to understand the relationships among the range of services that are offered by CPAs because different professional standards apply to each type of service. Figure 1.3 illustrates the universe of services that may be offered by CPAs and the relationships among these services. As shown, CPAs provide both assurance and nonassurance services, but a few, specifically of the management consulting type, overlap. Certain management consulting services have assurance aspects. Later in this chapter, we will provide a brief description of the prevalent types of nonassurance services offered by CPA firms.

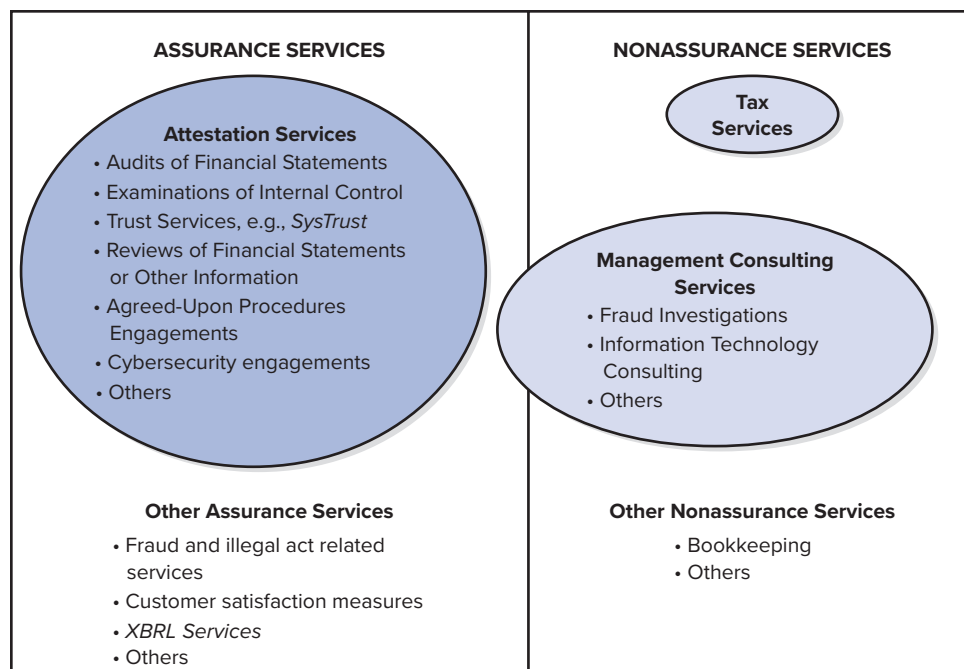
Figure 1.3 also illustrates that attestation services are only a portion of the assurance services that are offered by CPAs. Chapter 20 discusses a number of these services in detail.

FIGURE 1.2 Forms of Attestation

Type of Engagement	Level of Assurance Provided	Risk of Material Misstatement	Nature of Assurance in Report	Procedures
Examination*	High ("reasonable")	Low	"In our opinion . . ."	Select from all available procedures any combination that can limit attestation risk to a low level
Review	Limited	Moderate	"We are not aware of any material modifications that should be made . . ."	Generally limited to inquiry and analytical procedures
Agreed-Upon Procedures	Summary of findings	Varies by specific engagement	Includes a summary of procedures followed and findings	Procedures agreed upon with the engaging party

*Referred to as an *audit* when the subject matter is historical financial statements or internal control as a part of an integrated audit.

FIGURE 1.3
Relationships among
Assurance and Other
Services



Throughout the first 17 chapters of this textbook, we will focus primarily on the attest function as it relates to the audit of financial statements. Other types of attestation and assurance services are discussed in Chapters 18 through 21.

Financial Statement Audits

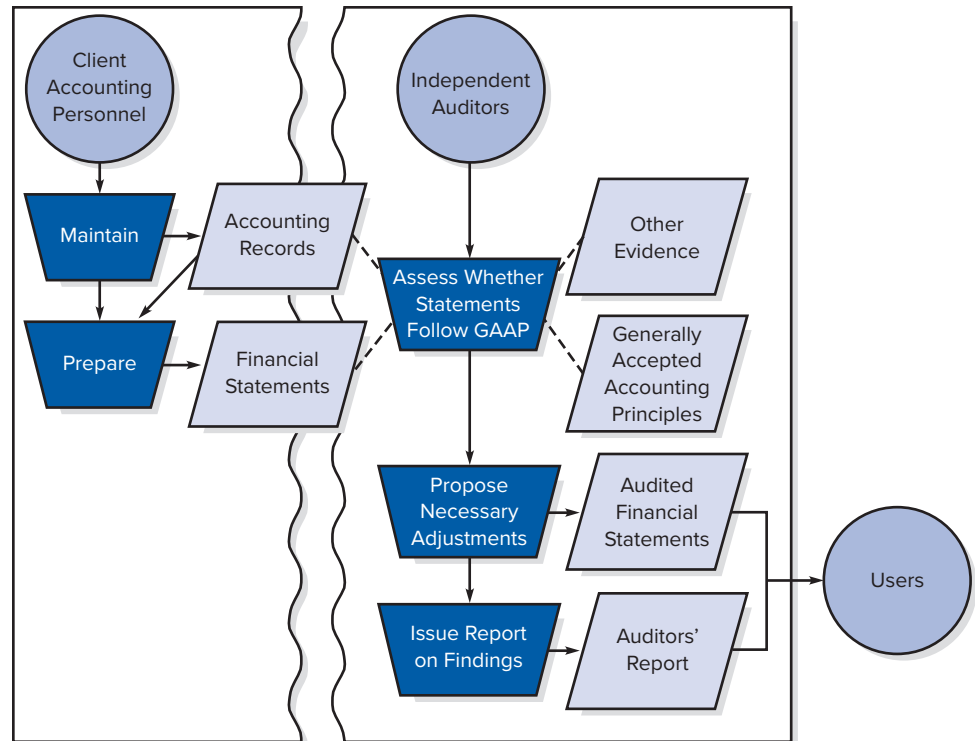
LO 1-3

Describe the nature of financial statement audits.

In a financial statement audit, the auditors undertake to gather evidence to obtain a high level of assurance (referred to as reasonable assurance) that the financial statements follow generally accepted accounting principles, or some other appropriate accounting framework. An audit involves searching and verifying the accounting records and examining other evidence supporting the financial statements. By gathering information about the company and its environment—including its internal control, inspecting documents, observing assets, making inquiries within and outside the company, and performing other auditing procedures—the auditors will gather the evidence necessary to issue an audit report. That audit report states that it is the auditors' opinion that the financial statements follow generally accepted accounting principles. The flowchart in Figure 1.4 illustrates an audit of financial statements.

The evidence obtained and evaluated by the auditors focuses on whether the financial statements are presented in accordance with the applicable financial reporting framework, usually generally accepted accounting principles. More specifically, an audit addresses management's assertions that the assets listed in the balance sheet really exist, that the company has rights (by title or contract) to the assets, and that the valuations assigned to the assets have been established in conformity with generally accepted accounting principles. Evidence is gathered to show that the balance sheet contains *all the liabilities* of the company; otherwise, the balance sheet might be grossly misleading because certain important liabilities have been accidentally or deliberately omitted. The auditors also obtain evidence that the recorded liabilities are actual obligations of the company and are properly valued. Similarly, the auditors gather evidence about the transactions recorded in the income statement. They demand evidence that the reported sales really occurred, that sales have been recorded at appropriate amounts, and that the recorded costs and expenses are applicable to the current period, and that all expenses have been recognized. Finally, the auditors consider whether the financial statement amounts are

FIGURE 1.4
Audit of Financial
Statements



accurate, properly classified and summarized, and whether the notes are informative and complete. Only if sufficient evidence is gathered in support of all these significant assertions can the auditors provide an opinion on whether the financial statements are presented in accordance with generally accepted accounting principles.

The procedures included in an audit vary considerably from one engagement to the next. Many of the procedures appropriate to the audit of a small retail store would not be appropriate for the audit of a large corporation such as Apple Inc. Auditors perform audits of all types of businesses, and of governmental and nonprofit organizations as well. Banks and breweries, factories and stores, colleges and churches, school districts and labor unions—all are regularly visited by auditors. The selection of the procedures best suited to each audit requires the exercise of professional skill and judgment.

What Creates the Demand for Audits?

LO 1-4

Explain why audits are demanded by society.

Reliable accounting and financial reporting aid society in allocating resources in an efficient manner. A primary goal is to allocate limited capital resources to the production of those goods and services for which demand is great. Economic resources are attracted to the industries, the geographic areas, and the organizational entities that are shown by financial measurements to be capable of using the resources to the best advantage. Inadequate accounting and reporting, on the other hand, conceal waste and inefficiency, thereby preventing an efficient allocation of economic resources in the society.

The contribution of the independent auditor is to provide *credibility* to information. Credibility, in this context, means that the information can be believed; that is, it can be relied upon by outsiders, such as stockholders, creditors, government regulators, customers, and other interested third parties. These third parties use the information to make various economic decisions, such as decisions about whether to invest in the organization.

Economic decisions are made under conditions of uncertainty; there is always a risk that the decision maker will select the wrong alternative and incur a significant loss. The credibility added to the information by auditors actually reduces the decision maker's risk. To be more precise, the auditors reduce information risk, which is the risk that the financial information used to make a decision is materially misstated.

Audited financial statements are the accepted means by which business corporations report their operating results and financial position. The word *audited*, when applied to financial statements, means that the balance sheet and the statements of income, retained earnings, and cash flows are accompanied by an audit report prepared by independent public accountants, expressing their professional opinion as to the fairness of the company's financial statements.

Financial statements prepared by management and transmitted to outsiders without first being audited by independent accountants leave a credibility gap. In reporting on its own administration of the business, management can hardly be expected to be entirely impartial and unbiased, any more than a football coach could be expected to serve as both coach and referee in the same game. Independent auditors should have no material personal or financial interest in the businesses; their reports can be expected to be impartial and free from bias.

Unaudited financial statements may have been honestly, but carelessly, prepared. Liabilities may have been overlooked and omitted from the balance sheet. Assets may have been overstated as a result of arithmetical errors or due to a lack of knowledge of generally accepted accounting principles. Net income may have been exaggerated because expenses were capitalized (i.e., misclassified as assets) or because sales transactions were recorded in advance of delivery dates.

Finally, there is the possibility that unaudited financial statements have been deliberately falsified in order to conceal theft and fraud or as a means of inducing the reader to invest in the business or to extend credit. Although deliberate falsification of financial statements is not common, it does occur and can cause devastating losses to persons who make decisions based upon such misleading statements.

For all these reasons (accidental errors, lack of knowledge of accounting principles, unintentional bias, and deliberate falsification), financial statements may depart from generally accepted accounting principles. Audits provide organizations with more credible financial statements to allow users to have more assurance that those statements do not materially depart from generally accepted accounting principles.

In *United States v. Arthur Young*, 465 U.S. 805 (1984), the Supreme Court described the auditor's role as being that of a public watchdog, requiring both total independence from the client at all times and a complete fidelity to the public trust. As such, the public accounting profession differs from other professions in that auditors do not typically perform services for the primary use of the party contracting for the service. Audits are primarily performed for other third parties, e.g., investors and creditors. The connections with these individuals are the reports issued by the auditors and read by and relied upon by the third parties. The auditors' reports are meant to provide value because the auditors have no material personal or financial interest in the business being audited; their reports can be expected to be impartial and free from bias.

Illustrating the Demand for Auditing

A decision by a bank loan officer about whether to make a loan to a business can be used to illustrate the demand for auditing. Since the bank's objective in making the loan is to earn an appropriate rate of interest and to collect the principal of the loan at maturity, the loan officer is making two related decisions: (1) whether to make the loan at all and (2) the rate of interest that adequately compensates the bank for the level of risk assumed. The loan officer will make these decisions based on a careful study of the company's financial statements along with other information. The risk assumed by the bank related to this customer has two aspects:¹

1. **Business risk**—the risk associated with a company's survival and profitability. This includes, for example, the risk that the company will not be able to make the interest payments and repay the principal of the loan because of economic conditions or poor management decisions. Business risk is assessed by considering factors such as the

¹ For all loans, the banker also assumes *interest rate risk*, which varies depending on the terms of the loan. Interest rate risk reflects the risk due to potential changes in the "risk-free" interest rate.

financial position of the company, the nature of its operations, the characteristics of the industry in which it operates, and the quality and integrity of its management.

2. **Information risk**—the risk that the information used to assess business risk is not accurate. Information risk includes the possibility that the financial statements might contain material departures from generally accepted accounting principles.

While auditing normally has only a limited effect on a company's business risk,² it can significantly affect the level of information risk. If the loan officer has assurance from the auditors that the company's financial statements are prepared in accordance with generally accepted accounting principles, they will have more confidence in their assessment of business risk. In addition, periodic audits performed after the loan has been made provide the loan officer with a way of monitoring management performance and compliance with the various loan provisions. By reducing information risk, the auditors reduce the overall risk to the bank; the loan officer is more likely to rely on the company's financial information, and if that information shows a healthy company, make the loan at a lower rate of interest. Therefore, management of the company has an incentive to provide audited financial statements to the loan officer to obtain the loan and to get the best possible interest rate.

The millions of individuals who have entrusted their savings to corporations by investing in securities rely upon annual and quarterly financial statements for investment decisions and for assurance that their invested funds are being used honestly and efficiently. An even greater number of people entrust their savings to banks, insurance companies, investment managers, and pension funds, which in turn invest the money in securities.

Various regulatory agencies also demand audit services. As an example, consider the income tax reporting system in the United States. The information provided on tax returns is provided by taxpayers and may be biased because of the self-interest of the providers. The government attempts to compensate for this inherent weakness through verification by audits carried out by agents of the Internal Revenue Service.

Corporate Governance and Auditing

The term **corporate governance** refers to the rules, processes, and laws by which businesses are operated, regulated, and controlled. Effective corporate governance requires that the interests of a company's management, shareholders, creditors, and other stakeholders be properly balanced. Shareholders elect **boards of directors** to oversee the corporation's activities. In the United States, public companies must establish **audit committees** of their board of directors, ordinarily composed of between three and six independent (nonmanagement) board members.³ Although details of responsibilities differ among companies, audit committees are charged with areas such as oversight of financial reporting, regulatory compliance, and risk management. Included in the audit committee's responsibilities is appointment, compensation, and oversight of the work of the company's external auditors. Chapter 7 provides more information on the relationship of corporate governance to internal control, including auditor responsibilities to communicate with audit committees.

A Brief Summary of Major Auditing Developments

Audits of one type or another have been performed throughout the recorded history of commerce and government finance. The original meaning of the word *auditor* was "one who hears" and was appropriate to the era during which governmental accounting records

² Possible effects of an audit on business risk include modifications of management's operating decisions either due to knowledge that an audit will be performed or due to operating recommendations made by auditors. Accordingly, an audit *may* reduce business risk.

³ Specifically, independent board members include those who are not employees of the company and do not receive consulting or other compensatory fees from the company (other than fees for serving on the board of directors and the audit committee). In addition, all members of the audit committee must be financially literate, while one member must be considered a "financial expert."

were approved only after a public reading, in which the accounts were read aloud. From medieval times on through the Industrial Revolution, audits were performed to determine whether persons in positions of official responsibility in government and commerce were acting and reporting in an honest manner.

During the Industrial Revolution, as manufacturing concerns grew in size, their owners began to use the services of hired managers. With this separation of the ownership and management groups, the absentee owners turned increasingly to auditors to protect themselves against the danger of unintentional errors as well as fraud committed by managers and employees. Bankers were the primary outside users of financial reports (usually only balance sheets), and they also were concerned with whether the reports were distorted by errors or fraud. Before 1900, consistent with this primary objective to detect errors and fraud, audits often included a study of all, or almost all, recorded transactions.

Auditing Developments in the 20th Century

In the first half of the 20th century, the direction of audit work tended to move away from fraud detection toward a new goal of determining whether financial statements gave a full and fair picture of financial position, operating results, and changes in financial position. This shift in emphasis was a response to the increasing number of shareholders and the corresponding increased size of corporate entities. In addition to the new shareholders, auditors became more responsible to governmental agencies, the stock exchanges representing these new investors, and other parties who might rely upon the financial information. No longer were bankers the only important outside users of audited financial data. The fairness of reported earnings became of prime importance.

As large-scale corporate entities developed rapidly in both Great Britain and the United States, auditors began to sample selected transactions, rather than study all transactions. Auditors and business managers gradually came to accept the proposition that careful examination of relatively few selected transactions would give a cost-effective, reliable indication of the accuracy of other similar transactions.

In addition to sampling, auditors became aware of the importance of effective internal control. A company's internal control consists of the policies and procedures established to provide reasonable assurance that the objectives of the company will be achieved, including the objective of preparing accurate financial statements. Auditors found that by studying the client's internal control, they could identify areas of strength as well as of weakness. *The stronger the internal control, the less testing of financial statement account balances required by the auditors.* For any significant account or any phase of financial operations in which controls were weak, the auditors expanded the nature and extent of their tests of the account balance.



With the increased reliance upon sampling and internal control, professional standards began to emphasize limitations on auditors' ability to detect **fraud**. The profession recognized that audits designed to discover fraud would be too costly. Effective internal control and corporate governance were recognized as better fraud protection techniques than audits.

Beginning in the 1960s, the detection of large-scale fraud assumed a larger role in the audit process. Professional standards, which used the term *irregularities* in place of fraud, described fraudulent financial reporting and misappropriation of assets. This shift in emphasis to taking a greater responsibility for the detection of fraud resulted from (1) a dramatic increase in congressional pressure to assume more responsibility for large-scale frauds, (2) a number of successful lawsuits claiming that fraudulent financial reporting (management fraud) had improperly gone undetected by the independent auditors, and (3) a belief by public accountants that audits should have a reasonable probability of detecting *material* fraud.

As a result of a number of instances of fraudulent financial reporting, the major accounting organizations established the Committee of Sponsoring Organizations (COSO),⁴ which sponsored the *National Commission on Fraudulent Financial Reporting*

⁴ The sponsoring organizations included the American Institute of Certified Public Accountants, the American Accounting Association, the Financial Executives Institute, The Institute of Internal Auditors, and the Institute of Management Accountants.

(the Treadway Commission) to study the causes of fraudulent reporting and make recommendations to reduce its incidence. The commission's report, which was issued in 1987, made a number of recommendations for auditors, public companies, regulators, and educators. Many of the recommendations for auditors were enacted by the AICPA in a group of *Statements on Auditing Standards* known as the *expectation gap* standards. The commission's recommendations about internal control led to the development of an internal control framework, titled *Internal Control—Integrated Framework*, to be used to evaluate an organization's internal control over financial reporting. This framework, referred to as the COSO internal control framework, was developed and is maintained and enhanced by the Committee of Sponsoring Organizations (COSO). Internal control and COSO are described in more detailed in Chapter 7.

In the late 1980s and early 1990s, the billions of dollars in federal funds that were required to “bail out” the savings and loan industry caused a movement toward increased regulation of federally insured financial institutions. Congress and regulatory agencies believed that the key to preventing such problems was enacting effective laws and regulations and requiring reports by auditors on compliance with provisions of these laws and regulations. An important example of this type of legislation is the FDIC Improvement Act of 1991. In addition to requiring reporting on internal control, the law also requires management of large financial institutions to engage its CPAs to attest to management's assertion about the institution's compliance with laws and regulations related to the safety and soundness of the institution.

In 1996, in response to a continuing expectation gap between user demands and auditor performance, the AICPA issued guidance to auditors requiring an explicit assessment of the risk of material misstatement in financial statements due to fraud on all audits. This auditing standard subsequently was updated to a more stringent standard that requires auditors to definitively design procedures to address the risk of fraudulent financial reporting.

The Accounting Profession's Credibility Crisis



In 2000, at the request of the Securities and Exchange Commission, the accounting profession established the Panel on Audit Effectiveness. The panel was charged with the responsibility of reviewing and evaluating how independent audits of financial statements are performed and assessing whether recent trends in audit practices serve the public interest. Recommendations from the panel resulted in changes in auditing standards related to the detection of fraud, documentation of audit evidence and judgments, risk assessments, and the linkage of audit procedures to audit risks. However, even before these changes in audit requirements could be implemented, a series of events in the capital markets produced a chain reaction that caused unprecedented reforms in the accounting profession.

LO 1-5

Describe how the credibility of the accounting profession was affected by the large number of companies reporting accounting irregularities in the beginning of this century.

In December 2001, Enron Corporation filed for bankruptcy shortly after acknowledging that accounting irregularities had been used to significantly inflate earnings in the current and preceding years. Shortly thereafter, it was disclosed that WorldCom had used accounting fraud to significantly overstate its reported income. In addition to these two very visible cases, a record number of public companies restated prior-period financial statements, and almost weekly the Securities and Exchange Commission announced a new investigation into another company's accounting practices. Investor uncertainty about the reliability of financial statements rocked an already weak financial market during the latter part of 2001 and the first half of 2002. It brought into question the effectiveness of financial statement audits and created a crisis of credibility for the accounting profession. More significantly, the highly publicized conviction of Arthur Andersen LLP, one of the then “Big 5” accounting firms, on charges of destruction of documents related to the Enron case brought into question the ethical principles of the public accounting profession.⁵

⁵ Ironically, the conviction of Andersen was overturned by the Supreme Court, but not before the firm had been dissolved.

	Illustrative Case	Massive Fraud at WorldCom
	WorldCom reported over \$11 billion in accounting irregularities, completely eliminating the company's previously reported profits for all of 2000 and 2001	and causing the company to declare bankruptcy. At one time WorldCom had reported total assets in excess of \$100 billion and a market value in excess of \$150 billion, making it then the largest bankruptcy in U.S. history.⁶

These events drew quick responses from a number of congressional committees, the SEC, and the U.S. Department of Justice, as they began investigating corporate management and the accounting profession. By the summer of 2002, Congress had passed the **Sarbanes-Oxley Act of 2002**, which significantly changed the responsibilities of management of public companies and their auditors.

Sections 302 and 404 of the Sarbanes-Oxley Act address the additional responsibilities of corporate management. Section 302 requires the principal executive officer and the principal financial officer to (1) review and certify financial reports filed with the SEC indicating that, to the best of their knowledge, the information and financial statements are fairly stated; (2) design and maintain effective internal control over financial reporting; (3) evaluate and report on the effectiveness of internal controls; and (4) disclose to the auditors and the audit committee any significant deficiencies in internal control and instances of fraud involving management or employees who have a significant role in internal control. Section 404 requires officers to annually issue a report on the effectiveness of internal control. Management of public companies with a market capitalization of more than \$75 million must engage the corporation's auditors to perform an integrated audit of financial statements and internal control.

The Sarbanes-Oxley Act also significantly affected the accounting profession by establishing the Public Company Accounting Oversight Board (PCAOB) to oversee auditors of public companies, and establishing various other requirements, including Section 404's requiring of audits of internal control and Section 201's restrictions on the types of consulting activities that CPAs may perform for public company audit clients. Establishment of the PCAOB, discussed in further detail later in this chapter, effectively eliminated the accounting profession's self-regulation of audits of public (issuer) companies.⁷

The Financial Crisis of 2008

The 2008 financial crisis that resulted from a collapse of the U.S. subprime market and the reversal of the housing boom in the United States and other industrialized economies caused Congress and regulators to reexamine laws and regulations regarding corporate governance and risk management, especially for large financial institutions. In response, Congress passed into law the **Dodd-Frank Act (the Wall Street Reform and Consumer Protection Act)** of 2010. This act's major purposes were to promote financial stability by improving accountability and transparency in the

⁶ The bankruptcy of Lehman Brothers Holding, Inc. in 2008 is now the largest bankruptcy in U.S. history.

⁷ The AICPA and the PCAOB often use the terms *issuer* and *nonissuer* to refer to public and nonpublic companies, respectively. An issuer is a company that has securities registered with the SEC. We will use the terms *public/issuer* and *nonpublic/nonissuer* synonymously throughout this textbook.

financial system and to protect the U.S. taxpayer by ending bailouts of “too-big-to-fail” institutions. These regulations must be considered by the auditors when auditing financial institutions.

The Effect of Information Technology

A major factor underlying many of the changes throughout the period has been advances in information technology. Information systems have evolved from handwritten journals and ledgers to small computer accounting systems to large mainframe computers to closely networked computer systems. As systems have changed (e.g., from enterprise-wide information systems to “cloud-based” accounting systems, and from over-the-counter sales to the general use of the Internet to initiate and process transactions), auditing methods have had to adapt. While technology has not changed the basic objective of the financial statement audit, it has resulted in the need for auditor knowledge of such systems. Automated tools and techniques (e.g., **artificial intelligence (AI)**, **machine learning**, and **robotic process automation**), whether used by management or auditors, are currently being developed at a rapid rate.

Technology-related change is beginning to provide auditors with opportunities to test entire populations electronically. For example, when auditors identify a weakness in control over a particular type of transaction (say, a particular category of cash disbursement), the availability of increasingly integrated databases is making possible an electronic examination of every transaction of that type that occurred during the year. As we indicated earlier, prior to 1900 entire populations were often examined—advances in technology are already bringing back that possibility in a number of areas.

Auditors must not only be able to understand their clients’ use of information technology; they also need to have the skills to develop innovative testing techniques and tools to assure audit effectiveness. For example, increasingly the audit role may include auditors working with data scientists to obtain and analyze relevant data.

Recap

Many of the ideas mentioned in this brief historical sketch of the development of auditing are analyzed in detail in later sections of this book. Our purpose at this point is to orient you with a quick overall look at some of the major auditing developments beginning with the 20th century through today. These many developments, while significant, may be overshadowed by future challenges the accounting profession faces related to its overall environment, including changes in information technology.

Types of Audits

LO 1-6

Contrast the various types of audits and types of auditors.

Audits are often viewed as falling into three major categories: (1) financial audits, (2) compliance audits, and (3) operational audits. In addition, the Sarbanes-Oxley Act requires an integrated audit for public companies.

Financial Audits

A **financial audit** involves an examination of the financial accounting information of an entity. An **audit of financial statements** ordinarily covers the balance sheet and the related statements of income, retained earnings, and cash flows. The goal is to determine whether these statements have been prepared in conformity with generally accepted accounting principles. Financial statement audits are normally performed by firms of certified public accountants; however, internal auditors often perform financial audits of departments or business segments. Users of auditors’ reports include management, investors, bankers, creditors, financial analysts, and government agencies.

Compliance Audits

The performance of a **compliance audit** is dependent upon the existence of verifiable data and of recognized criteria or standards, such as established laws and regulations or an organization’s policies and procedures. A familiar example is the audit of an income tax

return by an auditor of the Internal Revenue Service (IRS). Such audits address whether a tax return is in compliance with tax laws and IRS regulations. The findings of the IRS auditors are transmitted to the taxpayer by means of the IRS auditor's report.

Another example of a compliance audit is the periodic bank examination by bank examiners employed by the Federal Deposit Insurance Corporation and the state banking departments. These audits measure compliance with banking laws and regulations and with traditional standards of sound banking practice.

Internal auditors perform audits of compliance with internal controls, other company policies and procedures, and applicable laws and regulations. Internal audit departments often are involved with documenting and testing internal control for management's reports required by the Sarbanes-Oxley Act.

Finally, many state and local governmental entities and nonprofit organizations that receive financial assistance from the federal government must arrange for compliance audits under the Single Audit Act or *OMB Uniform Guidance*. Such audits are designed to determine whether the financial assistance is spent in accordance with applicable laws and regulations. Compliance audits are described in greater detail in Chapter 21.

Operational Audits

An **operational audit** is a study of a specific unit of an organization for the purpose of measuring its performance. The operations of the receiving department of a manufacturing company, for example, may be evaluated in terms of its *effectiveness*—that is, its success in meeting its stated goals and responsibilities. Performance is also judged in terms of *efficiency*—that is, success in using to its best advantage the resources available to the department. Because the criteria for effectiveness and efficiency are not as clearly established as are generally accepted accounting principles and many laws and regulations, an operational audit tends to require more subjective judgment than do audits of financial statements or compliance. For example, quantifiable criteria often must be developed by the auditors to be used to measure the effectiveness or efficiency of the department. Operational auditing is also discussed in detail in Chapter 21.

Integrated Audits

The Sarbanes-Oxley Act requires that auditors of larger publicly traded companies in the United States perform an **integrated audit** that includes providing assurance on both the financial statements and the effectiveness of internal control over financial reporting. Also, the Sarbanes-Oxley Act and PCAOB AS 2201, which implements the integrated audit, require company management to assess and report on the company's internal control. The auditors, in addition to providing an opinion on the company's financial statements, report on both management's assessment and internal control effectiveness.⁸

Types of Auditors

In addition to the audit of financial statements by certified public accountants, other professional groups carry on large-scale auditing programs. Among these other well-known types of auditors are internal auditors, auditors of the Government Accountability Office, and Internal Revenue agents.

Internal Auditors

Nearly every large corporation maintains an internal auditing staff. Internal auditors are also employed extensively by governmental and nonprofit organizations. A principal goal of internal auditors is to investigate and appraise the effectiveness with which the various organizational units of the company are carrying out their assigned functions. Much attention is given by internal auditors to the study and evaluation of internal control.

A large part of the work of internal auditors consists of operational audits; in addition, they may conduct numerous compliance audits. The number and kind of investigative

⁸ In 2010, the Dodd-Frank Act relieved the internal control audit requirement for issuers with a smaller market cap (essentially less than 75 million).

projects vary from year to year. Unlike CPAs, who are committed to verify each significant item in the annual financial statements, internal auditors are not obligated to repeat their audits on an annual basis.

The internal auditing staff often reports to the audit committee of the board of directors and also to the president or another high-level executive. This strategic placement high in the organizational structure helps ensure that the internal auditors will have ready access to all units of the organization, and that their recommendations will be given prompt attention by department heads. It is imperative that the internal auditors be independent of the department heads and other line executives whose work they review. Thus, it would generally not be desirable for the internal auditing staff to be under the authority of the corporate controller. Regardless of their reporting level, however, the internal auditors are not independent in the same sense as the independent auditors. The internal auditors are employees of the organization in which they work, subject to the restraints inherent in the employer–employee relationship. Nonetheless, the internal auditing standards promulgated by the Institute of Internal Auditors (IIA) require that they be objective in their evaluations.

The IIA is the international organization of internal auditors. It has developed various standards relating to internal auditing, and it administers the certified internal auditor (CIA) examination. Chapter 21 provides further discussion of the internal auditing profession and the CIA designation.

Government Accountability Office Auditors

Congress has long had its own auditing staff, headed by the comptroller general and known as the Government Accountability Office, or GAO.⁹ The work of GAO auditors includes compliance, operational, and financial audits. These assignments include audits of government agencies to determine that spending programs follow the intent of Congress and operational audits to evaluate the effectiveness and efficiency of selected government programs. GAO auditors conduct examinations of corporations holding government contracts to verify that contract payments by the government have been proper. In addition, the financial statements of a number of federal agencies and the consolidated financial statements of the federal government are audited by the GAO.

The enormous size of many of the federal agencies has caused the GAO to stress the development of data analytics and technology. Its pioneering in these areas has led to the recognition of the GAO as a sophisticated professional auditing organization.

Internal Revenue Agents

The Internal Revenue Service is responsible for enforcement of the federal tax laws. Its agents conduct compliance audits of the income tax returns of individuals and corporations to determine that income has been computed and taxes paid as required by federal law. Although IRS audits include some simple individual tax returns that can be completed in an hour or so in an IRS office, they also include field audits of the nation's largest corporations and often involve highly complex tax issues.

The Public Accounting Profession

LO 1-7

Explain the regulatory process for auditors of public companies and auditors of nonpublic companies.

In recognition of the public trust afforded to public accountants, each state recognizes public accountancy as a profession and issues the certificate of **certified public accountant (CPA)**. The CPA certificate is a symbol of technical competence. This official recognition by the state is comparable to that accorded to the legal, medical, and other professions.

The licensing of CPAs by the states reflects a belief that the public interest will be protected by an official identification of competent professional accountants who offer

⁹ The GAO changed its name from the General Accounting Office to the Government Accountability Office in 2004.

their services to the public. Although CPAs provide various types of tax, consulting, and accounting services that are also provided by non-CPAs, the various states generally restrict the performance of audits of financial statements to CPAs. It is this performance of the attest function on financial statements that is most unique to CPAs.

American Institute of Certified Public Accountants

The **American Institute of Certified Public Accountants (AICPA)** is a voluntary national organization of more than 418,000 members.¹⁰ The following five major areas of the AICPA's work are of particular interest to students of auditing:

1. Establishing standards and rules to guide CPAs in their conduct of professional services.
2. Carrying on a program of research and publication.
3. Promoting continuing professional education.
4. Contributing to the profession's self-regulation.
5. Developing and grading the Uniform CPA Examination.

Establishing Standards

The AICPA has assigned to its **Auditing Standards Board (ASB)** responsibility for establishing auditing standards for nonpublic organizations. A most important series of pronouncements on auditing by the Auditing Standards Board is entitled **Statements on Auditing Standards (SASs)**. The codification of the AICPA standards is presented in the text's Appendix. The preface AU-C is used to cite a particular section. Thus, for example, AU-C 300 addresses "Planning the Audit."

The AICPA also issues *Statements on Standards for Attestation Engagements (SSAEs)*. These statements provide CPAs with guidance for attesting to information other than financial statements, such as financial forecasts. Chapter 2 also provides a description of the SSAsEs.

The Accounting and Review Services Committee of the AICPA establishes standards for reporting on financial statements when the CPAs' role is to compile or review the financial statements rather than to perform an audit. The series of pronouncements by this committee is called *Statements on Standards for Accounting and Review Services (SSARSs)*. The SSARSs provide guidance for the many sensitive situations in which a public accounting firm is in some way associated with the financial statements of a nonpublic company and, therefore, needs to make clear the extent of the responsibility that the public accounting firm assumes for the fairness of the statements. SSARSs engagements are discussed more fully in Chapter 19.

Research and Publication

In addition to the professional standards indicated above, the AICPA issues additional technical guidance. Many accounting students are familiar with the *Journal of Accountancy*, published monthly. Another AICPA monthly journal is *The Tax Advisor*. Publications bearing directly on auditing and accounting include

- *Industry Audit and Accounting Guides*. These guides cover various industries, including, for example, Gaming Audit and Accounting Guide.
- *Audit Guides*. These guides provide additional guidance about specific audit techniques, including *Audit Sampling*.
- *Audit Risk Alerts*. These publications update auditors on practice issues and recently issued professional pronouncements that affect the audits of entities in various industries.

¹⁰ In the textbook we use "the AICPA" to refer to the American Institute of Certified Public Accountants, the largest organization of CPAs in the United States. The AICPA is one of the two sections of the Association of International Certified Professional Accountants (the Association), which may also be referred to as the AICPA due to the words in its title also beginning with those letters. The Association is the result of a joint venture of the American Institute of Certified Public Accountants and the Chartered Institute of Management Accountants (CIMA).

Continuing Professional Education

Another important activity of the AICPA is the development of a continuing professional education program. Continuing education is a necessity for CPAs to remain knowledgeable about the unending stream of changes in accounting principles, tax law, auditing, computers, and consulting services. Continuing education programs are offered by the AICPA, state societies, and other professional organizations. State laws require CPAs to participate in continuing education programs as a condition for license renewal.

Professional Regulation

Historically, most of the regulation of accounting firms has been performed by the accounting profession itself through the AICPA. While the SEC had provided oversight and some regulation prior to 2002, this situation changed significantly in 2002 with the passage of the Sarbanes-Oxley Act. As indicated previously, this legislation created the PCAOB, which eliminated the accounting profession's self-regulation of public company audits. The AICPA continues to regulate the accounting practices of accounting firms that do not audit public companies and the nonpublic practice of CPA firms with public clients.

Regulation of Individual CPAs The membership of the AICPA has adopted ethical rules for CPAs in the form of its goal-oriented *Code of Professional Conduct*. This ethical code sets forth positively stated principles on which CPAs can make decisions about appropriate conduct. The AICPA *Code of Professional Conduct* is described in detail in Chapter 3.

Self-regulation also is apparent in the requirements for regular membership in the AICPA, which include the following:

1. Members in public practice that practice with a firm that performs most accounting or auditing services must practice with a firm enrolled in an approved practice-monitoring (peer review) program.
2. Members must obtain continuing education: 120 hours every three years.

Regulation of Public Accounting Firms An AICPA member can meet the practice-monitoring membership requirement if their firm is enrolled in the AICPA Peer Review Program. When a CPA firm enrolls in the AICPA Peer Review Program, it agrees to comply with the AICPA's Quality Management Standards and to have a peer review of its accounting and auditing practice every 3½ years. A *peer review* involves a critical review of one public accounting firm's practices by another public accounting firm. Such an external review clearly offers a more objective evaluation of the quality of performance than could be made by self-review. The purpose of this concept is to encourage rigorous adherence to the AICPA's quality management standards. Quality management standards and the peer review process are discussed in detail in Chapter 2.

Firms that are not subject to PCAOB inspections are subject to peer reviews that are administered by the state CPA societies under the overall direction of the AICPA Peer Review Board. Firms that are required to be registered with and inspected by the PCAOB are required to have their AICPA peer review administered by the National Peer Review Committee. For these firms, the AICPA peer review focuses on the engagements that do not involve public companies and, therefore, are not covered by PCAOB inspections.

Many firms that are registered with the PCAOB become members of the AICPA *Center for Audit Quality (CAQ)*. The CAQ is dedicated to enhancing investor confidence and public trust in the global capital markets by fostering high-quality performance by public company auditors; convening and collaborating with other stakeholders to advance the discussion of critical issues requiring action and intervention; and advocating policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions.

The AICPA—In Perspective

Throughout its existence, the AICPA has contributed enormously to the evolution of generally accepted accounting principles as well as to the development of professional

standards. The many technical divisions and committees of the institute (such as the Auditing Standards Board) provide a means of focusing the collective experience and ability of the profession on current problems. However, with the passage of the Sarbanes-Oxley Act, the AICPA's influence and responsibility have been significantly diminished.

The CPA Examination

The **CPA examination** is a uniform national examination prepared and graded by the American Institute of Certified Public Accountants. The exam is computerized and given on demand at computer centers throughout the year.

Although the preparation and grading of the examination are in the hands of the AICPA, the issuance of CPA certificates is a function of each state or territory. Passing the CPA examination does not, in itself, entitle the candidate to a CPA certificate; states have experience and education requirements that must be met before the CPA certificate and permits to practice are issued.

The CPA examination is aimed at providing reasonable assurance that candidates who pass have the appropriate skills and knowledge to perform as newly licensed CPAs (i.e., CPAs with limited experience, often as little as one year). The exam covers both knowledge and the application of higher-order skills such as analysis and evaluation. Beginning in 2024, the exam was changed to reflect the rapidly changing skills and competencies required to practice as a CPA. The exam consists of the following three core sections:

1. Auditing and Attestation (AUD)
2. Financial Accounting and Reporting (FAR)
3. Taxation and Regulation (REG)

In addition to the core sections, candidates elect to sit for one of the following three discipline exams:

- Business Analysis and Reporting (BAR)
- Information Systems and Controls (ISC)
- Tax Compliance and Planning (TCP)

The exam sections consist of multiple-choice questions and simulations, which are designed to replicate “real-world” practice cases. The compilation of questions and problems included in this textbook involved a review of CPA questions used in prior years and the selection of representative questions and problems. Use of this material is with the consent of the AICPA. Many other problems and questions (not from CPA examinations) also are included in each chapter.

State Boards of Accountancy

Permits to practice as a CPA are granted by the state boards of accountancy in the various states. These boards also regulate the profession and may suspend or revoke an accountant's certificate. While all state boards require successful completion of the CPA examination, the requirements for education and experience vary. A few states require only a baccalaureate degree, while most require 150 semester hours of education or a master's degree to obtain a permit to practice. The experience required generally ranges from none to two years. The state boards are organized through the National Association of State Boards of Accounting (NASBA).

Financial Accounting Standards Board

Auditors should determine whether financial statements are prepared in conformity with generally accepted accounting principles. Both the SEC and the AICPA have designated the Financial Accounting Standards Board as the body with power to set forth these principles for entities other than federal, state, and local governments. Thus, *FASB Statements* (and related codification), exposure drafts, public hearings, and research projects are all of major concern to the public accounting profession.

The structure, history, and pronouncements of the FASB (and its predecessor, the Accounting Principles Board) are appropriately covered in introductory, intermediate, and advanced accounting courses.

Governmental Accounting Standards Board

The Governmental Accounting Standards Board (GASB) was formed in 1984 to establish and improve standards of financial accounting for state and local government entities. The operational structure of the GASB is similar to that of the FASB. Auditors of state and local government entities, such as cities and school districts, look to the GASB pronouncements for the appropriate accounting principles.

Federal Accounting Standards Advisory Board

In 1990, the federal Office of Management and Budget, the U.S. Treasury, and the General Accounting Office (since renamed the Government Accountability Office) established the Federal Accounting Standards Advisory Board (FASAB) to develop accounting standards for the U.S. government. This body issues standards that are used to audit a number of major federal agencies and the U.S. government as a whole as required by the Government Management Reform Act of 1994.

The Public Company Accounting Oversight Board

As indicated previously, the **Public Company Accounting Oversight Board (PCAOB)** was created in 2002 to oversee public accounting firms that audit public (issuer) companies. In 2010, the Dodd-Frank Act expanded the PCAOB's scope of responsibility to include overseeing audits of securities brokers and dealers. The PCAOB has four primary duties:

- Register public accounting firms that prepare audit reports for issuers, brokers, and dealers.
- Establish or adopt auditing and related attestation, quality control, ethics, and independence standards.
- Inspect registered firms' audits and quality control systems.
- Investigate and discipline registered public accounting firms and their associated persons for violations of specified laws, rules, or professional standards.

The PCAOB's five members—only two of whom are CPAs—are selected from among prominent individuals who have demonstrated a commitment to the interests of investors and the public and an understanding of the issues faced by the PCAOB. Members are appointed by the Securities and Exchange Commission and may serve no more than two five-year terms.

The PCAOB originally adopted the AICPA Auditing Standards Board's *Statements on Auditing Standards* that were in effect as of April 16, 2003, as its interim standards for audits of public companies and began issuing its own *Auditing Standards* to update and supplement the interim standards. In 2015, the PCAOB reorganized and integrated the interim and subsequently issued auditing standards into one overall framework. That framework is presented in the text's Appendix. The PCAOB standards use AS for the preface for a particular section. For example, PCAOB AS 2101 addresses "Audit Planning."

All accounting firms that audit SEC registrants or brokers and dealers must register with the PCAOB. As part of that registration process, each firm pledges to cooperate with any inquiry made by the PCAOB. The PCAOB may impose monetary damages and may suspend firms and accountants from working on engagements for publicly traded companies. It also may make referrals to the Justice Department to consider criminal cases.

PCAOB staff perform inspections of the public company audit practices of **registered public accounting firms** for compliance with the Sarbanes-Oxley Act, PCAOB and SEC requirements, and professional standards. CPA firms that audit more than 100 public companies are inspected annually, and firms that audit 100 or fewer public companies

are inspected at least every three years. The results of the inspections are posted on the PCAOB's website at www.pcaob.org. Inspections and additional reviews are discussed in detail in Chapter 2.

Securities and Exchange Commission

The **Securities and Exchange Commission (SEC)** is an agency of the U.S. government. It administers the Securities Act of 1933, the Securities Exchange Act of 1934, and other legislation concerning securities and financial matters. In addition, the SEC has oversight responsibility for the PCAOB. The primary function of the SEC is to protect investors and the public by requiring full disclosure of financial information by companies offering securities for sale to the public. A second objective is to prevent misrepresentation, deceit, or other fraud in the sale of securities.

The term *registration statement* is an important one in any discussion of the impact of the SEC on accounting practice. To *register* securities means to qualify them for sale to the public by filing with the SEC financial statements and other data in a form acceptable to the commission. A registration statement contains *audited financial statements*, including balance sheets for a two-year period and income statements, statements of retained earnings, and statements of cash flows for a three-year period.

The legislation creating the SEC made the commission responsible for determining whether the financial statements presented to it reflect proper application of accounting principles. To aid the commission in discharging this responsibility, the securities acts provide for an examination and report by a public accounting firm registered with the Public Company Accounting Oversight Board. From its beginning, the SEC has been a major user of audited financial statements and has exercised great influence upon the development of accounting principles, the strengthening of auditing standards, and the concept of auditor independence.

Protection of investors, of course, requires that the public have available the information contained in a registration statement concerning a proposed issue of securities. The issuing company is therefore required to deliver to prospective buyers of securities a *prospectus*, or selling circular, from the registration statement. The registration of securities does not insure investors against loss; the SEC does not pass on the merit of securities. There is, in fact, only one purpose of registration: to provide disclosure of the important facts so that the investor has available all pertinent information on which to base an intelligent decision as to whether to buy a given security. If the SEC believes that a given registration statement does not meet its standards of disclosure, it may require amendment of the statement or may issue a stop order preventing sale of the securities.

To improve the quality of the financial statements filed with it and the professional standards of the independent accountants who report on these statements, the SEC has adopted a basic accounting regulation known as *Regulation S-X* and entitled *Form and Content of Financial Statements*. Between 1937 and 1982, the SEC issued 307 *Accounting*



Illustrative Case

Exiting and Reentering the Consulting Business

After passage of the Sarbanes-Oxley Act, most of the large CPA firms sold or spun off their consulting practices. As examples, IBM bought the consulting practice of PricewaterhouseCoopers LLP, KPMG LLP spun off its consulting

practice and took it public, and Ernst & Young LLP sold its consulting practice to Cap Gemini. Nonetheless, in recent years, these firms have started providing increasing amounts of such services. However, the types of such services that they may provide for their attest clients are limited, as is discussed in detail in Chapter 3.

Series Releases (ASRs) addressing various accounting and auditing issues. In 1982, the series was replaced by two series—*Financial Reporting Releases* and *Accounting and Auditing Enforcement Releases*. *Financial Reporting Releases* present the SEC's current views on financial reporting and auditing issues. *Accounting and Auditing Enforcement Releases* summarize enforcement activities against auditors when the SEC has found deficiencies in the auditors' work. In addition, the standards of the PCAOB must be adopted through the SEC's regulation process.

The International Federation of Accountants

The **International Federation of Accountants (IFAC)** is the global organization of accounting professional bodies. Members of IFAC are not individuals. Instead, membership consists of approximately 175 professional accountancy bodies (e.g., the AICPA) from approximately 130 countries and jurisdictions. IFAC was established to help foster a coordinated worldwide accounting profession with harmonized standards. Boards established by IFAC have the following responsibilities:

- The **International Auditing and Assurance Standards Board (IAASB)** establishes *International Standards on Auditing (ISAs)*, *International Standards on Quality Management (ISQM)*, and standards for other assurance and related services.
- The **International Ethics Standards Board for Accountants (IESBA)** establishes ethical standards and guidance for professional accountants.
- The **International Accounting Education Standards Board (IAESB)** develops guidance to improve accounting education around the world.

The pronouncements of these boards do not override the national auditing standards of its members. Rather, they are meant to foster the development of consistent worldwide professional standards. Members from countries that do not have their own standards are encouraged to adopt IFAC standards. Members from countries that already have standards are encouraged to compare them to IAASB standards and seek to eliminate any material inconsistencies.

The AICPA's Auditing Standards Board's general strategy is to converge its auditing and assurance standards with those of the IAASB. It has structured its standards using the IAASB frameworks (included in the Appendix at the end of the book) and has passed standards with very similar (or identical) format and content. Often, the Auditing Standards Board's approach to establishing a new *Statement on Auditing Standards* is to use a new IAASB pronouncement as a starting point.

Sustainability Standards

The **Sustainability Accounting Standards Board (SASB)** was established in 2011 to assist businesses and investors by developing a common set of criteria related to a company's environmental, social, and governance (ESG) prospects. Since its inception, the board has established standards across a range of industries to guide management in disclosure of sustainability information to investors. In 2022, the SASB merged with the International Federation of Accountants, and the standards of the SASB became the basis for a new set of standards issued by the **International Sustainability Standards Board (ISSB)**. While the SEC has not embraced ISSB standards for disclosures, companies are required to disclose material sustainability information in their SEC filings. Given the appetite of investors for sustainability information, it is expected that more companies will adopt sustainability disclosure standards for their financial reports, and attestation to the information by auditors may also eventually be required. To assist in reporting, and attesting to, sustainability information, COSO has recently issued *Achieving Effective Internal Control Over Sustainability Reporting (ICSR): Building Trust and Confidence through the COSO–Integrated Framework*, to provide guidance on developing and assessing internal control over sustainability disclosures.

Other Types of Professional Services

In addition to auditing and other assurance services, public accounting firms offer other types of services to their clients, including tax services, consulting services, accounting and review services, fraud investigation services, and personal financial planning. Public accounting firms tend to specialize in particular types of services depending on their size and the expertise of their personnel.

Tax Services

Tax services that are performed by public accounting firms fall into two broad categories: compliance work and tax planning. Compliance work involves preparing the federal, state, and local tax returns of corporations, partnerships, individuals, and estates and trusts. Tax planning, on the other hand, involves consulting with clients on how to structure their business affairs to legally minimize the amount and postpone the payment of their taxes.

Consulting Services

Public accounting firms offer a variety of services that are designed to improve the effectiveness and efficiency of their clients' operations. Initially, these services developed as a natural extension of the audit and primarily involved consulting on accounting and internal control systems. In recent years, public accounting firms have expanded by offering a host of additional services that tend to be more operational in nature. Examples are developing strategic planning models and management information systems and performing executive search services.

The large CPA firms have become leaders in IT implementation and maintenance, particularly as it relates to accounting information systems. For example, firms are able to help clients take advantage of advances in **data analytics**, artificial intelligence, and **blockchain** technology. As **fifth-generation (5G) digital technology** continues to develop, the various technologies will be affected. CPA firms will provide consulting services using combinations of these techniques to enhance information systems. They will also use the technology to make possible real-time verification of business transactions and further enhance the ability of audits of full financial data sets.

Performance of consulting services for audit clients has been a significant issue with respect to the independence of auditors, so much so that a number of restrictions have been placed on the types and extent of consulting services that may be performed for public company audit clients. This issue will be discussed in more detail in Chapter 3.

Accounting and Review Services

Audits are expensive. For a small business, the cost of an audit will run into thousands of dollars; for large corporations, the cost may exceed a million dollars. The most common reason for a small business to incur the cost of an audit is the influence exerted by a bank that insists upon audited financial statements as a condition for granting a bank loan. If a small business is not in need of a significant amount of bank credit, the cost of an audit may exceed its benefits.

An alternative is to retain a public accounting firm to perform other services for non-public (nonissuer) companies, such as the preparation, compilation, or review of financial statements. For both preparation and compilation engagements, the accountants prepare the financial statements; these services are often rendered when the client does not have accounting personnel capable of preparing statements. While no report is usually issued for a preparation engagement, for a compilation engagement the public accounting firm issues a compilation report on the financial statements that provides *no assurance* that the statements are presented fairly in accordance with generally accepted accounting principles.

A review of financial statements by a public accounting firm is an attestation service that is substantially less in scope than an audit. It is designed to provide *limited assurance* on the credibility of the statements. A review stresses inquiries by the CPA and the comparison of amounts in the statements to comparable financial and nonfinancial data.

These comparisons, which are referred to as analytical procedures, are useful in bringing to light possible misstatements of financial statement amounts. Financial statement preparation, compilation, and review services are discussed in Chapter 19.

Litigation Support Services

The level of litigation in the United States has created a fast-growing area of practice. CPAs are often used in business litigation cases as expert witnesses to calculate damages or explain complex business and accounting concepts to judges and juries. As a result, many public accounting firms have developed departments that specialize in litigation support services.

Fraud Investigation Services



Fraud investigation services generally involve engaging professionals to investigate suspected or known fraud. These types of services are also referred to as *forensic accounting services*, but forensic accounting is somewhat broader and includes litigation support services. Because of increased identified incidences of defalcation and theft, fraud investigation has become a significant part of the work performed by many internal audit departments. These types of services are also a practice specialty for many public accounting firms. To demonstrate expertise in the area of fraud investigation, the designation “Certified Fraud Examiner” has been developed by the Association of Certified Fraud Examiners.

Personal Financial Planning

Public accounting firms also may advise individuals on their personal financial affairs. For example, a public accounting firm may review a client’s investment portfolio and evaluate whether the nature of the investments meets the client’s financial objectives. The public accounting firm might also advise the client on the nature and amount of insurance coverage that are appropriate. The AICPA offers the designation “Personal Financial Specialist” to CPAs who satisfy certain experience requirements and pass a one-day examination on personal financial planning topics, such as income tax planning, risk management planning, investment planning, retirement planning, and estate planning.

Organization of the Public Accounting Profession

LO 1-8

Describe how public accounting firms are typically organized and the responsibilities of auditors at the various levels in the organization.

Many public accounting firms are organized as either sole practitioners or partnerships. A CPA also may practice as a member of a professional corporation or, in many states, as a *limited liability partnership (LLP)* or a *limited liability company (LLC)*.

Professional corporations differ from traditional corporations in a number of respects. For example, all shareholders and directors of a professional corporation must be engaged in the practice of public accounting. In addition, shareholders and directors of the professional corporation may be held personally liable for the corporation’s actions, although they may choose to carry liability insurance to cover damages caused by negligent actions. *Limited liability partnerships (companies)* are similar to professional corporations, but they provide for the protection of the personal assets of any shareholders or partners not directly involved in providing services on engagements resulting in litigation.

In comparison with a sole proprietorship, partnerships and professional corporations with multiple owners have several advantages. When two or more CPAs join forces, the opportunity for specialization is increased, and the scope of services offered to clients may be expanded. Also, qualified members of the staff may be rewarded by admission to the partnership or issuance of stock. Providing an opportunity to become part owner of the business is an important factor in the public accounting firm’s ability to attract and retain competent personnel.

Public accounting firms range in size from one person to over 100,000 on the professional staff. In terms of size, public accounting firms are often grouped into the following four categories: local firms, regional firms, national firms, and Big 4 firms.

Local Firms

Local firms typically have one or two offices, include only one CPA or a few CPAs as partners, and serve clients in a single city or area. These firms often emphasize income tax, consulting, and accounting services. Auditing is usually only a small part of the practice and tends to involve small business concerns that find a need for audited financial statements to support applications for bank loans.

Regional Firms

Many local firms have become regional firms by opening additional offices in neighboring cities or states and increasing the number of professional staff. Merging with other local firms is often a route to regional status. This growth is often accompanied by an increase in the amount of auditing as compared to other services.

National Firms

Public accounting firms with offices in most major cities in the United States are called national firms. These firms may operate internationally as well, either with their own offices or through affiliations with firms in other countries. RSM, Grant Thornton, and BDO are three such firms.

Big 4 Firms

The “Big 4” public accounting firms are Deloitte, EY, KPMG, and PwC. Each of these firms has extensive operations in the United States and internationally. Because only a very large public accounting firm has sufficient staff and resources to audit a giant corporation, these firms audit nearly all of the largest American and multinational corporations.

Associations of CPA firms

To improve their capabilities to provide professional services, many CPA firms join a group of firms, typically structured as an **association**. Associations are separate legal entities that are designed to help their member firms to increase the availability of services and resources that they provide. For example, a CPA firm with operations in only one city may use the resources of the association to help provide services to clients in other locations. The Illustrative Case on the BDO Alliance USA provides further illustrations of suggested advantages of an association.

Also important is the concept of a **network** of CPA firms. An association is considered a network when the relationship among firms includes sharing at least one of the following: (1) common brand name, (2) common control, (3) profits, (4) common business strategy, (5) significant professional resources, and (6) common quality management policies and procedures. Each of the Big 4 as well as a number of smaller CPA firms is actually composed of a group of associated firms that qualify as a network. It is the Big 4 networks with revenues well into the billions of dollars in total that make possible the

	Illustrative Case	The BDO Alliance USA
firms. Its materials suggest that its members obtain advantages, including • Access to tax and assurance professionals around the world. • Access to industry-specific resources. • Collaborative go-to-market opportunities.	BDO, a large American CPA firm, established an association (its “alliance”) with smaller CPA firms.	• Continuing professional education programs and courses. • Improved practice management. • Customizable marketing, advertising, and presentation materials. • Networking opportunities, including regional and national alliance conferences. Members of the alliance pay various fees to obtain such services.

audit of large multinational companies. As indicated in Chapter 3, a network firm must comply with the Independence Rule of the AICPA Code of Professional Conduct with respect to attest clients of other network firms.

Alternative Practice Structure Firms

Beginning in the late 1990s, a number of publicly traded companies—including American Express, CBIZ Inc., and H&R Block—began purchasing public accounting firms. These companies are often referred to as “consolidators” because they purchase public accounting firms in various cities and consolidate them into the overall corporation. In essence, the approach is to purchase the nonattest portion of the practice, hire public accounting firm partners and other personnel as employees of the publicly traded company, and perform those services. The attest and auditing partners retain that status in the public accounting firm, but ordinarily, they are also employees of the publicly traded company. The public accounting firm then provides attestation services, using partners and other staff members leased from the public company. Ethical complications of these structures are discussed in Chapter 3.

Industry Specialization

Public accounting firms have long recognized the value of industry specialization. When they possess a detailed knowledge and understanding of a client’s industry, the auditors can be more effective at collecting and evaluating audit evidence. Also, they are in a better position to make valuable suggestions that will improve the client’s operations and to provide the client consulting services.

A number of large public accounting firms have organized their firms along industry lines. Each industry group is made up of personnel involved in providing audit, tax, and consulting services for a specialized industry. The firms believe that such an organizational structure leads to the performance of higher-quality integrated services to firms in specialized industries.

Responsibilities of the Professional Staff

Human resources—the competence, judgment, and integrity of personnel—represent the greatest asset of any public accounting firm. While the title of partner ordinarily exists for personnel providing services in the various divisions of a CPA firm (e.g., auditing and taxation), the titles may differ somewhat by the type of service provided at other levels. Typical titles for the auditing division includes partners, managers, senior auditors, and staff auditors.

Partners

The partnership level in a public accounting firm is comparable to that of top management in an industrial organization. Partners are the owners of the firm and are compensated in part directly from the firm’s profits—as such, they are referred to as “equity partners” because they invest in the firm and share profits.

Some CPA firms have a second group of partners—“nonequity partners.” These partners are, in essence, high-level employees rather than members of management, although a number may be on track to become equity partners. While they generally are able to provide input into firm matters, they do not have a vote in partner meetings. The remainder of this section focuses on the role of equity partners.

The lead partner (“engagement partner”) on an engagement is responsible for assuring that the audit is performed in accordance with applicable professional standards. Accordingly, this individual is ultimately responsible for adequate planning, supervision, and execution of the audit. Partners are also responsible for maintaining primary contacts with clients. These contacts include discussing with clients the objectives and scope of the audit work, resolving controversies that may arise as to how items are to be presented in the financial statements, and attending the client’s stockholders’ meetings to answer any questions regarding the financial statements or the auditors’ report.

Other responsibilities of the partner include attracting new clients, recruiting new staff members, supervising the professional staff, reviewing audit working papers, and signing the audit reports.

Specialization by each partner in a different area of the firm's practice is often advantageous. One partner, for example, may have expertise in tax matters and head the firm's tax department; another may specialize in SEC registrations; a third may devote full time to design and installation of information systems.

While partners deal with the long-run well-being of the organization, they also become involved in the community the firm serves. They contribute significant time to civic, professional, and educational activities in the community. Participation in the state society of certified public accountants and in the AICPA is, of course, important if the partners are to do their share in building the profession. Contribution of their specialized skills and professional judgment to leadership of civic organizations is equally important to developing the economic and social environment in which business and professional accomplishment is possible.

An important aspect of partners' active participation in various business and civic organizations is the prestige and recognition that may come to their firms. Many clients select a particular public accounting firm because they have come to know and respect one of the firm's partners. Thus, partners who are widely known and highly regarded within the community may be a significant factor in attracting business to the firm.

Managers

In large public accounting firms, managers or supervisors perform many of the duties that would be discharged by partners in smaller firms. A manager may be responsible for supervising two or more concurrent audit engagements. This supervisory work includes reviewing the audit working papers and discussing with the audit staff and with the client any accounting or auditing problems that may arise during the engagement. The manager is responsible for determining the audit procedures applicable to specific audits and for maintaining uniform standards of fieldwork. Often, managers have the administrative duties of compiling and collecting the firm's billings to clients.

Familiarity with tax laws, as well as a broad and current knowledge of accounting theory and practice, is an essential qualification for a successful manager. Like the partner, the audit manager may specialize in specific industries or other areas of the firm's practice.

In addition to the nonequity partner position described earlier, a number of firms include other titled positions between manager and equity partner. For example, firms may have titled positions such as senior manager, director, and managing director. Ordinarily, individuals in these positions are highly skilled and compensated; in many situations, they are in essence "equity partners in training." However, these individuals do not vote on firm matters and do not directly share in firm profits.

Senior Auditors

The responsibility assumed by the senior "in-charge" auditor varies based on the size of the engagement. On a smaller engagement, the senior auditor may assume responsibility for planning and conducting the audit and drafting the audit report, subject to review and approval by the manager and partner. On larger engagements, a senior auditor may assume responsibility for supervising some aspects of the audit, such as the audit of accounts receivable. In conducting the audit, the senior will delegate most audit tasks to assistants based on an appraisal of each assistant's ability to perform particular phases of the work. A well-qualified university graduate with a formal education in accounting may progress from staff accountant to senior auditor within two or three years, or even less.

One of the major responsibilities of the senior is on-the-job staff training. In assigning work to staff accountants, the senior should make clear the end objectives of the particular audit procedure. By assigning assistants a wide variety of audit tasks and by providing constructive criticism of the assistants' work, the senior should try to make each audit a significant learning experience for the staff accountants.

Reviewing working papers shortly after they are completed is another duty of the senior in charge of an audit. This enables the senior to control the progress of the work and to ascertain that each phase of the engagement is adequately covered. At the conclusion of the fieldwork, the senior will make a final review, including tracing items from individual working papers to the financial statements.

The senior also will maintain a continuous record of the hours devoted by all members of the staff to the various phases of the audit. In addition to maintaining uniform professional standards of fieldwork, the senior is responsible for preventing the accumulation of excessive staff hours on inconsequential matters and for completing the entire engagement within the budgeted time, if possible.

Staff Auditors

The first position of a college graduate entering the public accounting profession is that of staff auditor (staff accountant, staff assistant, or associate). Staff auditors usually encounter a variety of assignments that fully utilize their capacity for analysis and growth. Of course, some routine work must be done in every audit engagement, but college graduates with thorough training in accounting need have little fear of being assigned for long to extensive routine procedures when they enter the field of public accounting. Most firms are anxious to increase the assigned responsibility to younger staff members as rapidly as they are able to assume it. Ordinarily, the demand for accounting services is so high as to create a situation in which every incentive exists for the rapid development of promising assistants.

Increasingly automation is replacing routine procedures previously manually performed by staff accountants. Advances in technology may be expected to continue that process into increasingly sophisticated areas relating to the financial statements. Increasingly important will be having staff members who can “ask the right questions” that allow the running of appropriate data queries. Subsequently, staff will often provide the first level of overall review analysis and that of exceptions identified. As we discussed earlier in the chapter, these analyses are now often being performed on entire populations of transactions rather than samples.

The audit staff members of all public accounting firms attend training programs that are either developed “in house” or sponsored by professional organizations. One of the most attractive features of the public accounting profession is the richness and variety of experience acquired even by the beginning staff member. Because of the high



Illustrative Case

Firm Evolution

Traditionally, a typical CPA firm partner and employee structure has been viewed as a pyramid—a few partners at the top, many staff associates at the bottom, and the numbers at other ranks (managers, seniors) in between. Some have suggested that the shape will change in the future due to factors such as:

- Hiring of fewer staff accountants due to electronic performance of many traditional tasks.
- Hiring of more IT specialists on either a full-time or a part-time basis (e.g., more IT full-time specialist employees, “gig workers,” and other independent contractors).
- A higher level of IT skills for many non-IT specialist employees.

An effect of such change may be “replacement” of the pyramid by a figure with a narrow top (partners, owners), a fat middle (experienced auditors and more specialists [IT and other]), and a somewhat more narrow bottom than the historical level (fewer staff accountants than in the past). Yet, there is a strong belief that the need for audits will persist and that accounting financial statement–related skills will continue to be very valuable to the individual and firm.

quality of the experience gained by certified public accountants as they move from one audit engagement to another, many business concerns select individuals from the public accounting field to fill such executive positions as controller or treasurer.

Professional Development for Public Accounting Firm Personnel

A major challenge in public accounting is keeping abreast of current developments within the profession. New business practices; new pronouncements by the Auditing Standards Board, the PCAOB, the SEC, the FASB, and the GASB; and changes in the tax laws are only a few of the factors that require members of the profession continually to update their technical knowledge.

A public accounting firm should make certain that the professional staff remains continuously up-to-date on technical issues. To assist in this updating process, most large public accounting firms maintain a separate professional development section.

Professional development sections offer a wide range of seminars and educational programs to personnel of the firm. The curriculum of each program is especially designed to suit the needs and responsibilities of participants. Partners may attend programs focusing on the firm's policies on audit quality management or current developments in a specialized industry; on the other hand, programs designed for staff accountants may cover audit procedures or use of the firm's audit software. In addition to offering educational programs, the professional development section usually publishes a monthly newsletter or journal for distribution to personnel of the public accounting firm and other interested persons.

As discussed earlier, many small public accounting firms have banded together into associations. These associations organize educational programs, distribute information on technical issues, and engage in other professional activities that are designed to meet the needs of their members. Because the costs of the association's professional activities are shared by all members, the firms are provided with many of the benefits of having their own professional development department at a fraction of the cost.

Seasonal Fluctuations in Public Accounting Work

One of the traditional disadvantages of the public accounting profession has been the concentration of work during the "busy season" from December through April, followed by a period of slack demand during the summer months. This seasonal trend is caused by the fact that many companies keep their records on a calendar-year basis and require auditing services immediately after the December 31 closing of the accounts. Another important factor is the spring deadline for filing of federal income tax returns.

Auditors often work a considerable number of hours of overtime during the busy season. Some public accounting firms pay their staff for overtime hours. Other firms allow their staff to accumulate the overtime in an "overtime bank" and to "withdraw" these hours in the form of additional vacation time during the less busy times of the year. Others simply consider it a part of the salaried position's requirements.

Relationships with Clients

The wide-ranging scope of public accountants' activities today demands that CPAs be interested in and well informed on economic trends, political developments, and other topics that play a significant part in business and social contacts. Although an in-depth knowledge of accounting is the most important qualification of the CPA, an ability to meet people easily and to gain their confidence and goodwill may be no less important in achieving success in the profession of public accounting. The ability to work effectively with clients will be enhanced by a sincere interest in their problems and by a relaxed and cordial manner.

The question of the auditor's independence inevitably arises in considering the advisability of social activities with clients. The partner in today's public accounting firm may

play golf or tennis with the executives of client companies and other business associates. These relationships actually may make it easier to resolve differences of opinions that arise during an audit, if management comes to know and respect the partner. This mutual understanding need not prevent the CPA from standing firm on matters of accounting principle. Alternatively, such relationships have the potential for impairing auditor independence. Auditor response to differences of opinions when such relationships exist is perhaps the “moment of truth” for the practitioners of a profession.

The CPA must always remember that the concept of independence embodies an *appearance* of independence. This appearance of independence may be impaired if an auditor becomes excessively involved in social activities with clients. For example, if a CPA frequently attends lavish parties held by a client or dates an officer or employee of a client corporation, the question might be raised as to whether the CPA will appear independent to outsiders. This dilemma is but one illustration of the continual need for judgment and perspective on the part of the auditor.

Chapter Summary

This chapter explored the nature of assurance services, the attest function, independent audits, and the auditing profession. To summarize:

1. CPAs provide a wide array of information enhancement services referred to as assurance services. Currently, the primary type of assurance service provided by CPAs involves attestation. When performing attestation services, CPAs enhance the reliability of information by issuing an examination, review, or agreed-upon procedures report on the subject matter or an assertion that it is the responsibility of another party. In the case of financial statement audits, the report most frequently includes an opinion about whether management's financial statements conform to generally accepted accounting principles.
2. Because audits involve examinations of financial information by independent experts, they increase the credibility of the information contained in the statements. Decision makers both within and outside the organization can use audited financial information with confidence that it is not likely to be materially misstated. Audits reduce information risk and, therefore, they reduce the overall risk of making various types of economic decisions.
3. The nature and emphasis of auditing have changed over the years. Auditing began with the objective of detecting fraud by examination of all, or most, business transactions. Today the objective of an audit is to attest to the fairness of the financial statements. Although the large size of business organizations resulted in the use of sampling techniques in auditing, changes in technology are making it possible to audit all transactions of particular types in an increasing number of situations.
4. Due to a number of very visible instances of fraudulent financial reporting, Congress passed the Sarbanes-Oxley Act of 2002. This act significantly changed the nature of audits of public (issuer) companies, as well as the regulation of auditors that perform such audits. The act created the Public Company Accounting Oversight Board (PCAOB) to regulate audits and auditors of public companies. In addition, CPAs are being asked to assume more responsibility for attesting to compliance with laws and regulations and the effectiveness of controls.
5. The auditing profession is much broader than auditors involved in public accounting; it also includes internal auditors and various governmental auditors, such as auditors of the Government Accountability Office and the Internal Revenue Service.
6. Various professional and regulatory organizations have a significant influence on the auditing profession, including the American Institute of Certified Public Accountants, the Financial Accounting Standards Board, the Governmental Accounting Standards Board, the Federal Accounting Standards Advisory Board, the Public

Company Accounting Oversight Board, the Securities and Exchange Commission, and the International Federation of Accountants.

7. The professional auditing staff of a typical medium-to-large public accounting firm includes partners, managers, senior auditors, and staff auditors. Information technology specialists are gaining a more prominent role in audits.
8. In addition to performing attestation engagements, public accounting firms offer tax services, consulting services, and accounting and review services. Public accounting firms range in size from sole practitioners to the large international firms referred to as the Big 4 firms.

Key Terms Introduced or Emphasized in Chapter 1

Agreed-upon procedures engagement (3) An attestation engagement in which a practitioner performs specific procedures on subject matter and reports the findings without providing an opinion or a conclusion on it.

American Institute of Certified Public Accountants (AICPA) (14) The national professional organization of CPAs engaged in promoting high professional standards to ensure that CPAs serve the public interest.

Applicable financial reporting framework (2) The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation of the financial statements that are acceptable in view of the nature of the entity and the objectives of the financial statements, or that is required by law or regulation.

Artificial intelligence (AI) (11) The theory and development of computer systems able to perform tasks that normally require human intelligence. General examples of such tasks include visual perception, speech recognition, decision making, and translation between languages. In an auditing context, electronically performing various analyses historically performed by humans is hoped to increase both the efficiency and quality of audits.

Assertion (2) A representation or declaration made by the responsible party, typically management of the entity.

Association (of CPA firms) (22) A separate legal entity composed of otherwise unrelated CPA firms. Associations allow member firms to enhance their capabilities to provide professional services (e.g., to refer work to, or receive referrals from, other association members).

Assurance services (1) Professional services that enhance the quality of information, or its context, for decision makers. Many assurance services involve some form of attestation.

Attestation (attest) engagement (1) An examination, review, or agreed-upon procedures engagement performed under the attestation standards related to subject matter or an assertion that is the responsibility of another party.

Audit committee (7) A committee of a corporation's board of directors that engages, compensates, and oversees the work of the independent auditors, monitors activities of the internal auditing staff, and intervenes in any disputes between management and the independent auditors. Members of the audit committee must be independent directors, that is, members of the board of directors who do not also serve as corporate officers or have other relationships that might impair independence.

Audit of financial statements (11) An examination designed to provide an opinion, the CPA's highest level of assurance that the financial statements follow generally accepted accounting principles, or another acceptable basis of accounting.

Auditing Standards Board (ASB) (14) The AICPA's senior committee for auditing, attestation, and quality control applicable to the performance and issuance of audit and attestation reports for nonpublic companies (nonissuers).

Blockchain (20) A decentralized database that maintains a continuously growing list of ordered records called blocks. A blockchain allows various parties to share a digital decentralized ledger across a network of computers without a centralized authority (e.g., such as a bank). Proponents argue that a blockchain allows the recording of transactions across computers in such a way that the transactions cannot be altered retroactively. This allows those involved to have confidence in the accuracy of the transactions.

Board of directors (7) Individuals elected by a corporation's shareholder to oversee the activities of the corporation. A board of directors ordinarily is composed of executives from the company and nonexecutive directors.

Business risk (of the client) (6) The risk assumed by investors or creditors that is associated with the company's survival and profitability.

Certified public accountant (CPA) (13) A person licensed by the state to practice public accounting as a profession, based on having passed the Uniform CPA Examination and having met certain educational and experience requirements.

Compliance audit (11) An audit to measure the compliance of the organization with some established criteria (e.g., laws and regulations, or internal control policies and procedures).

Corporate governance (7) The rules, processes, and laws by which businesses are operated, regulated, and controlled. A primary concern of corporate governance is the nature and extent of accountability of people in the corporation and procedures to try to assure that the organization works in the best interests of its stakeholders.

CPA examination (16) A uniform examination administered by the American Institute of Certified Public Accountants for state boards of accountancy to enable them to issue CPA licenses. The examination covers the topics of accounting and reporting, auditing, business environment, regulation, and professional responsibilities.

Data analytics (20) Analyses applied to raw data with the purpose of drawing conclusions about relationships. Data analytics is being used by management to get insights into how to improve the effectiveness and efficiency of operations. It is also used as a part of the management review to monitor the performance of other internal controls. Auditors are increasingly using data analytics to improve the effectiveness of certain audit procedures.

Dodd-Frank Act (the Wall Street Reform and Consumer Protection Act) (10) A U.S. federal law that increases federal government regulation of the financial industry. The legislation, enacted in July 2010, aims to prevent a major financial crisis by creating new financial regulatory processes that are aimed at enforcing transparency and accountability while implementing rules for consumer protection. The act also expands the Public Company Accounting Oversight Board's authority to oversee audits of brokers and dealers.

Examination (3) An attest engagement designed to provide the highest level of assurance that CPAs provide on subject matter. An examination of financial statements is referred to as an *audit*.

Fifth-generation (5G) digital technology (20) The latest iteration of cellular technology, engineered to greatly increase the speed and responsiveness of wireless networks. 5G will also enable a large increase in the amount of data that can be transmitted over wireless systems due to increased available bandwidth and advanced antenna technology.

Financial audit (11) An audit of the financial accounting information of an organization or segment of the organization. This may involve a complete set of financial statements or a portion of a statement.

Financial reporting framework (2) A set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements; for example, accounting principles generally accepted in the United States of America, or *International Financial Reporting Standards (IFRS)* issued by the International Accounting Standards Board (IASB).

Fraud (8) Intentional misstatement of financial statements by management (fraudulent financial reporting), or theft of assets by employees (employee fraud). Fraud also is referred to as *irregularities*.

Generally accepted accounting principles (GAAP) (2) Concepts or standards established by such authoritative bodies as the FASB and the GASB and accepted by the accounting profession as essential to proper financial reporting.

Information risk (7) The risk that the information used by investors, creditors, and others to assess business risk is materially misstated.

Integrated audit (12) An audit in which auditors, in addition to an opinion on the financial statements, express an opinion on the effectiveness of a company's internal control over financial reporting, in accordance with PCAOB AS 2201. Public companies with a market capitalization of \$75,000,000 or more are required to undergo integrated audits.

International Accounting Education Standards Board (IAESB) (19) A committee of the International Federation of Accountants, established to develop guidance to improve the standards of accountancy education around the world. The organization focuses on (1) the essential elements of accreditation, which are education, practical experience, and tests of professional competence, and (2) the nature and extent of continuing professional education needed by accountants.

International Auditing and Assurance Standards Board (IAASB) (19) A committee of the International Federation of Accountants, established to issue standards on auditing and reporting practices to improve the degree of uniformity of auditing practices and related services throughout the world.

International Ethics Standards Board for Accountants (IESBA) (19) A committee of the International Federation of Accountants, established to develop ethical standards and guidance for use by professional accountants. It encourages member bodies to adopt high standards of ethics for their members and promotes good ethical practices globally. The IESBA also fosters international debate on ethical issues faced by accountants.

International Federation of Accountants (IFAC) (19) A worldwide organization of national accounting bodies established to help foster a coordinated worldwide accounting profession with harmonized standards.

International Sustainability Standards Board (ISSB) (19) A board formed with the merger of the Sustainability Accounting Standards Board and the International Federation of Accountants to issue criteria related to environmental, social, and governance disclosure by companies.

Machine learning (11) An application of artificial intelligence (AI) that provides systems the ability to automatically learn and improve from experience without being explicitly programmed. Machine learning focuses on the development of computer programs that can access data and use it to learn for themselves.

Network (of CPA firms) (22) An association of CPA firms that shares at least one of the following with other firms: (1) common brand name, (2) common control, (3) profits, (4) common business strategy, (5) significant professional resources, and (6) common quality control policies and procedures.

Operational audit (12) An analysis of a department or other unit of a business or governmental organization to measure the effectiveness and efficiency of operations.

Public Company Accounting Oversight Board (PCAOB) (17) A board established by the Sarbanes-Oxley Act of 2002 to provide oversight of accounting firms that audit public companies by (1) establishing or adopting professional and ethical standards, (2) conducting inspections of CPA firms, and (3) enforcing compliance with professional and ethical standards. The board is composed of five individuals appointed by the SEC.

Registered public accounting firm (17) A public accounting firm registered with the Public Company Accounting Oversight Board in accordance with the Sarbanes-Oxley Act of 2002. Any CPA firm auditing SEC reporting companies must be registered.

Review (3) An engagement designed to express limited assurance relating to subject matter or an assertion. As discussed in further detail in Chapter 19, the procedures performed are generally limited to inquiries and analytical procedures.

Robotic process automation (11) The use of software with artificial intelligence (AI) and machine learning capabilities to handle high-volume, repeatable tasks that previously required humans to perform. For example, these tasks can include queries, calculations, and maintenance of records and transactions.

Sarbanes-Oxley Act of 2002 (10) A set of reforms that toughened penalties for corporate fraud, restricted the kinds of consulting CPAs can perform for audit clients, and created the Public Company Accounting Oversight Board to oversee CPAs and public accounting firms.

Securities and Exchange Commission (SEC) (18) A government agency authorized to regulate companies seeking approval to issue securities for sale to the public.

Statements on Auditing Standards (SASs) (14) A series of statements issued by the Auditing Standards Board of the AICPA. Generally accepted auditing standards are developed and issued in the form of SASs in the context of an audit of financial statements performed by an auditor.

Suitable criteria (2) The standards or benchmarks used to measure and present the subject matter and against which the CPA evaluates the subject matter. Suitable criteria are criteria that are established or developed by groups composed of experts that follow due process procedures, including exposure of the proposed criteria for public comment. Suitable criteria must have each of the following attributes: objectivity, measurability, completeness, and relevance.

Sustainability Accounting Standards Board (SASB) (19) A board established in the United States in 2011 to provide guidance on disclosure of sustainability information in financial reports to investors. The SASB has merged with the International Federation of Accountants (IFAC), and the existing standards will become the basis of standards issued by the International Sustainability Standards Board.

United States v. Arthur Young (6) The Supreme Court case that establishes the overall, legal responsibility of accountants who perform audits of a client. The key provision of this case is the concept that the audit profession serves as a watchdog, requiring complete independence from the client and fidelity to the public trust.

Review Questions

- 1-1. In late 2001 through 2002, the accounting profession faced a “crisis of credibility.” Describe the events that led up to this crisis.
- 1-2. Define assurance services. What are the two distinct types?
- 1-3. What is the most common type of attest engagement? What is most frequently being “asserted” by management on this type of engagement?
- 1-4. What are the principal use and significance of an audit report to a large corporation with securities listed on a stock exchange? To a small family-owned enterprise?
- 1-5. Describe several business situations that would create a need for a report by an independent public accountant concerning the fairness of a company’s financial statements.
- 1-6. Explain the following statement: One contribution of the independent auditor is to lend *credibility* to financial statements.
- 1-7. The overall risk of the investment in a business includes both business risk and information risk. Contrast these two types of risk. Which one is most directly affected by the auditors?
- 1-8. Contrast the objectives of auditing at the beginning of this century with the objectives of auditing today.
- 1-9. Comment on whether you agree with the following: Today’s sophisticated information systems make auditing of samples necessary, and auditing of an entire population impossible.
- 1-10. What does an operational audit attempt to measure? Does an operational audit involve more or fewer subjective judgments than a compliance audit or an audit of financial statements? Explain. To whom is the report usually directed after completion of an operational audit?
- 1-11. Distinguish between a compliance audit and an operational audit.
- 1-12. Is an *independent status* possible or desirable for internal auditors as compared with the independence of a public accounting firm? Explain.
- 1-13. Spacecraft Inc. is a large corporation that is audited regularly by a public accounting firm but also maintains an internal auditing staff. Explain briefly how the relationship of the public accounting firm to Spacecraft differs from the relationship of the internal auditing staff to Spacecraft.
- 1-14. Describe briefly the function of the GAO.
- 1-15. List two of the important contributions to auditing literature by the AICPA.
- 1-16. What is meant by a *peer review* in public accounting?
- 1-17. How does the role of the SEC differ from that of the AICPA?
- 1-18. Apart from auditing, what other professional services are offered by public accounting firms?
- 1-19. What are the advantages of organizing a public accounting firm as a partnership rather than a sole proprietorship?
- 1-20. How does a professional corporation differ from a traditional corporation?
- 1-21. Public accounting firms are sometimes grouped into categories of local firms, regional firms, national firms, and international firms. Explain briefly the characteristics of each. Include in your answer the types of services stressed in each group.
- 1-22. Describe the various levels or positions of accounting personnel in a large public accounting firm.
- 1-23. List three of the more important responsibilities of a partner in a public accounting firm.
- 1-24. What characteristics make an accounting association an accounting network?
- 1-25. What is the International Auditing and Assurance Standards Board? What is the purpose of its pronouncements? Do these pronouncements establish standards that override a member nation’s auditing standards?

Questions Requiring Analysis LO 1-5, 7

- 1-26. As a result of a number of events that caused Congress to doubt the ability of the accounting profession to regulate itself, a number of reforms were made to the accounting profession’s system of self-regulation.
 - a. Provide a brief overview of the legislation that altered the self-regulation process of the accounting profession.
 - b. Explain the regulation process for accounting firms that audit public companies.
 - c. Explain the regulation process for accounting firms that do not audit public companies.

- LO 1-4** 1–27. A corporation is contemplating issuing debenture bonds to a group of investors.
- Explain how independent audits of the corporation's financial statements facilitate this transaction.
 - Describe the likely effects on the transaction if the corporation decides not to obtain independent audits of its financial statements.
- LO 1-5, 7** 1–28. The Sarbanes-Oxley Act of 2002 created the Public Company Accounting Oversight Board. Explain the major responsibilities of this board.
- LO 1-4** 1–29. The self-interest of the provider of financial information (whether an individual or a business entity) often runs directly counter to the interests of the user of the information.
- Give an example of such opposing interests.
 - What may be done to compensate for the possible bias existing because of the self-interest of the individual or business entity providing the financial information?
- LO 1-7** 1–30. Various organizations develop standards for audits and regulate CPA firms. Compare and contrast the roles of the AICPA, the PCAOB, and the state boards of accountancy along the following dimensions:
- Standard setting.
 - Regulation of CPA firms.
 - Source of authority.

Objective Questions

LO 1-1, 2

Select questions are available with Connect.



- LO 1-1, 2** 1–31. **Multiple Choice Questions**
- Select the best answer for each of the following items and give reasons for your choice.
- LO 1-3** a. Which of the following best describes the relationship between assurance services and attest services?
- (1) While attest services involve financial data, assurance services involve nonfinancial data.
 - (2) While attest services require objectivity, assurance services do not require objectivity.
 - (3) All attest services require independence.
 - (4) Attest and assurance services are different terms referring to the same types of services.
- LO 1-3** b. Which of the following has primary responsibility for the fairness of the representations made in financial statements?
- (1) Client's management.
 - (2) Independent auditor.
 - (3) Audit committee.
 - (4) AICPA.
- LO 1-3** c. The most important benefit of having an annual audit by a public accounting firm is to:
- (1) Provide assurance to investors and other outsiders that the financial statements are reliable.
 - (2) Enable officers and directors to avoid personal responsibility for any misstatements in the financial statements.
 - (3) Meet the requirements of government agencies.
 - (4) Provide assurance that illegal acts, if any exist, will be brought to light.
- LO 1-7** d. The Sarbanes-Oxley Act created the Public Company Accounting Oversight Board (PCAOB). Which of the following is *not* one of the responsibilities of that board?
- (1) Establish independence standards for auditors of public companies.
 - (2) Review financial reports filed with the SEC.
 - (3) Establish auditing standards for audits of public companies.
 - (4) Sanction registered audit firms.
- LO 1-7** e. Which of these organizations has the responsibility to perform inspections of auditors of public companies?
- (1) American Institute of Certified Public Accountants.
 - (2) Securities and Exchange Commission.
 - (3) Financial Accounting Standards Board.
 - (4) Public Company Accounting Oversight Board.

- LO 1-6** *f.* Governmental auditing, in addition to including audits of financial statements, often includes audits of efficiency, effectiveness, and:
- (1) Adequacy.
 - (2) Evaluation.
 - (3) Accuracy.
 - (4) Compliance.
- LO 1-6** *g.* In general, internal auditors' independence will be greatest when they report directly to the:
- (1) Financial vice president.
 - (2) Corporate controller.
 - (3) Audit committee of the board of directors.
 - (4) Stockholders.
- LO 1-5** *h.* Which of the following did *not* precipitate the passage of the Sarbanes-Oxley Act of 2002 to regulate public accounting firms?
- (1) Disclosures related to accounting irregularities at Enron and WorldCom.
 - (2) Restatements of financial statements by a number of public companies.
 - (3) Conviction of the accounting firm of Arthur Andersen LLP.
 - (4) Ethical scandals at the AICPA.
- LO 1-6** *i.* Which of the following organizations establishes accounting standards for U.S. government agencies?
- (1) The Financial Accounting Standards Board.
 - (2) The Governmental Accounting Standards Board.
 - (3) The Federal Accounting Standards Advisory Board.
 - (4) The Public Company Accounting Oversight Board.
- LO 1-6** *j.* Which of the following is correct about forensic audits?
- (1) All audit engagements are forensic in nature.
 - (2) Forensic audits are performed by law firms; they are not performed by CPA firms.
 - (3) Forensic audits are equivalent to compliance audits.
 - (4) Forensic audits are usually performed in situations in which fraud has been found or is suspected.
- LO 1-3** *k.* What best describes the purpose of the auditors' consideration of internal control in a financial statement audit for a nonpublic company?
- (1) To determine the nature, timing, and extent of audit testing.
 - (2) To make recommendations to the client regarding improvements in internal control.
 - (3) To train new auditors on accounting and control systems.
 - (4) To identify opportunities for fraud within the client's operations.
- LO 1-6** *l.* Which of the following is an example of a compliance audit?
- (1) An audit of financial statements.
 - (2) An audit of a company's policies and procedures for adhering to environmental laws and regulations.
 - (3) An audit of a company's internal control over financial reporting.
 - (4) An audit of the efficiency and effectiveness of a company's legal department.
- (AICPA, adapted)
- LO 1-3** 1–32. The role of the auditor in the American economy has changed over the years in response to changes in our economic and political institutions. Consequently, the nature of an audit today is quite different from that of an audit performed in the year 1900. Classify the following phrases into two groups: (1) phrases more applicable to an audit performed in 1900 and (2) phrases more applicable to an audit performed today.
- a.* Complete review of all transactions.
 - b.* Assessment of internal control.
 - c.* Auditors' attention concentrated on balance sheet.
 - d.* Emphasis upon use of sampling techniques.
 - e.* Determination of fairness of financial statements.

- f. Audit procedures to prevent or detect fraud on the part of all employees and managers.
- g. Registration statement.
- h. Fairness of reported earnings per share.
- i. Influence of stock exchanges and the investing public upon use of independent auditors.
- j. Concern about fraudulent financial reporting.
- k. Generally accepted auditing standards.
- l. Bankers and short-term creditors as principal users of audit reports.
- m. Pressure for more disclosure.
- n. Auditing for compliance with laws and regulations.

LO 1-7 1–33. Auditors should be familiar with available professional literature from a variety of sources. Listed next are 11 publications in the fields of auditing and accounting.

- a. *Statements on Auditing Standards (SASs)*.
- b. *The Journal of Accountancy*.
- c. *Regulation S-X, Form and Content of Financial Statements*.
- d. *Statements on Standards for Accounting and Review Services (SSARSs)*.
- e. *Financial Reporting Releases (FRRs)*.
- f. *Accounting and Reporting Standards for Corporate Financial Statements*.
- g. *Accounting and Reporting Standards for Governmental Entities*.
- h. *Industry Audit and Accounting Guides*.
- i. *Audit Risk Alerts*.
- j. *The Tax Advisor*.
- k. *Auditing Standards*

The list of organizations shown here includes the sponsors or publishers of the preceding 11 publications.

- 1. Accounting Principles Board (APB).
- 2. Securities and Exchange Commission (SEC).
- 3. American Institute of Certified Public Accountants (AICPA).
- 4. Financial Accounting Standards Board (FASB).
- 5. Internal Revenue Service (IRS).
- 6. Government Accountability Office (GAO).
- 7. Governmental Accounting Standards Board (GASB).
- 8. Public Company Accounting Oversight Board.

Identify the sponsoring organization for each of the 11 publications. (Some of the organizations may not have a publication in this list.) Organize your answer in a two-column format. In the left-hand column, list the number and name of each publication in the order shown above. In the right-hand column, list the identifying number and the abbreviation of the sponsoring organization. For example, on line 1, list (a) *Statements on Auditing Standards* in the left column and (3) AICPA in the right column.

LO 1-3, 7 1–34. Each auditing term (or organizational name) in Column 1 below bears a close relationship to a term in Column 2.

Column 1	Column 2
1. Quality management	a. Regulation of auditors of public companies
2. Operational audit	b. Opinion
3. Internal control	c. Material information
4. Government Accountability Office	d. Credibility
5. Disclosure	e. Peer review
6. Critical characteristic that must be maintained by the accounting profession	f. Registration statement
7. Public Company Accounting Oversight Board	g. Accounting service
8. Securities and Exchange Commission	h. Measurement of effectiveness and efficiency of a unit of an organization
9. Audited financial statements	i. Basis for sampling and testing
10. Compilation of financial statements	j. Auditing staff reporting to Congress

Identify the most closely related terms in Columns 1 and 2. Organize your answer in a two-column format by copying the numbers and terms in Column 1 as given. Then, rearrange the sequence of terms in Column 2 so that each line of your schedule will contain two closely related terms.

- LO 1-6** 1–35. CPAs become involved in a variety of types of engagements. For each of the following statements, indicate whether it relates to an examination (E), review (R), or agreed-upon procedures (A) engagement. If the statement does not relate to examinations, reviews, or agreed-upon procedures, reply N.

Statement	Type of Engagement
a. When financial statements are involved, this is referred to as an audit.	
b. The term “We are not aware of any material modifications that should be made” is often included in the report.	
c. The report issued provides a summary of procedures performed (determined by the user) and findings.	
d. The report issued provides “reasonable assurance.”	
e. The procedures involved are generally limited to inquiry and analytical procedures.	
f. The report issued provides “absolute assurance.”	
g. The report issued provides “limited assurance.”	
h. The procedures followed are agreed upon with the specified user or users.	
i. This type of engagement provides more assurance than a review.	
j. The CPA need not be independent to perform this service.	

- LO 1-1, 2, 6** 1–36. Match the following definitions (or partial definitions) of the various types of services to the appropriate service. Each service may be used once or not at all.

Definition (or Partial Definition)	Service
a. An attest engagement in which the CPAs agree to perform procedures for a specified party and issue a report that is restricted to use by that party.	1. Agreed-upon procedures engagement
b. An engagement designed to express limited assurance relating to subject matter or an assertion.	2. Assurance services
c. An engagement in which the CPAs issue an examination, a review, or an agreed-upon procedures report on subject matter or an assertion about subject matter that is the responsibility of another party (e.g., management).	3. Attest engagement
d. An examination designed to provide an opinion that is the CPA's highest level of assurance that the financial statements follow generally accepted accounting principles, or another acceptable basis of accounting.	4. Audit of financial statements
e. As required by the Sarbanes-Oxley Act and the Public Company Accounting Oversight Board, an audit that includes providing assurance on both the financial statements and internal control over financial reporting.	5. Compliance audit
f. Professional services that enhance the quality of information, or its context, for decision makers.	6. Examination
g. An attest engagement designed to provide the highest level of assurance that CPAs provide on an assertion.	7. Integrated audit
	8. Operational audit
	9. Review

- LO Various** 1–37. Match the following definitions (or partial definitions) of the various types of services to the appropriate term. Each term may be used once or not at all.

Definition (or Partial Definition)	Service
a. A government agency authorized to regulate companies seeking approval to issue securities for sale to the public.	1. American Institute of Certified Public Accountants
b. A representation or declaration made by the responsible party, typically management of the entity.	2. Assertion
c. A series of statements issued by the Auditing Standards Board of the AICPA. Generally accepted auditing standards are developed and issued in the form of these statements.	3. Financial Accounting Standards Board
d. A set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements.	4. Financial reporting framework
e. A set of reforms that toughened penalties for corporate fraud, restricted the kinds of consulting CPAs can perform for audit clients, and created the Public Company Accounting Oversight Board to oversee CPAs and public accounting firms.	5. Integrated audit
f. The five-member board established in 2002 to oversee the audit of public (issuer) companies that are subject to the securities laws. The board has authority to establish or adopt (or both) rules for auditing, quality management, ethics, independence, and other standards relating to the preparation of audit reports.	6. Public Company Accounting Oversight Board
g. The national professional organization of CPAs engaged in promoting high professional standards to ensure that CPAs serve the public interest.	7. Sarbanes-Oxley Act of 2002
h. The standards or benchmarks used to measure and present the subject matter and against which the CPA evaluates the subject matter. They are criteria that are established or developed by groups composed of experts that follow due process procedures, including exposure of the proposed criteria for public comment.	8. Securities and Exchange Commission
	9. Statements on Auditing Standards
	10. Subject matter
	11. Suitable criteria

- LO 1-3, 6** 1–38. For the purposes of this problem, assume the existence of five types of auditors: CPA, GAO, IRS, bank examiner, and internal auditor. Also assume that the work of these various auditors can be grouped into five classifications: audits of financial statements, compliance audits, operational audits, accounting services, and consulting services. For each of the following topics, you are to state the type of auditor most probably involved. Also, identify the topic with one of the above classes of work. You should organize your answer in a three-column format as follows: Column 1, the letter of the topic; Column 2, the type of auditor involved; and Column 3, the class of work.
- Financial statements of a small business to be submitted to a bank in support of a loan application.
 - Financial statements of a large bank listed on the New York Stock Exchange to be distributed to stockholders.
 - Review of the management directive stating the goals and responsibilities of a corporation's mail-handling department.
 - Review of costs and accomplishments of a military research program carried on within the air force to determine whether the program was cost-effective.
 - Examination on a surprise basis of Midtown State Bank. Emphasis placed on verification of cash, marketable securities, and loans receivable and on consistent observation of the banking code.

- f. Analysis of the accounting system of a small business with the objective of making recommendations concerning installation of a computer-based system.
- g. Determination of fairness of financial statements for public distribution by a corporation that has a professional-level internal auditing staff.
- h. Review of the activities of the receiving department of a large manufacturing company, with special attention to efficiency of materials inspection and promptness of reports issued.
- i. Review of the tax return of the corporate president to determine whether charitable contributions are adequately substantiated.
- j. Review of daily attendance during spring term at Blue Ridge Consolidated School District to ascertain whether payments received from the state were substantiated by pupil-day data and whether disbursements by the district were within authorized limits.
- k. Review of transactions of a government agency to determine whether disbursements under the Payment-In-Kind program of the U.S. Department of Agriculture followed the intent of Congress.
- l. Compilation of quarterly financial statements for a small business that does not have any accounting personnel capable of preparing financial statements.

Problems LO 1-3, 4

- 1–39. Feller, the sole owner of a small hardware business, has been told that the business should have its financial statements audited by an independent CPA. Feller, having some bookkeeping experience, has personally prepared the company's financial statements and does not understand why such statements should be audited by a CPA. Feller discussed the matter with Farber, a CPA, and asked Farber to explain why an audit is considered important.

- a. Describe the objectives of an independent audit.
- b. Identify five ways in which an independent audit may be beneficial to Feller.

LO 1-3

- 1–40. In a discussion between Peters and Ferrel, two auditing students, Peters made the following statement: "A CPA is a professional person who is licensed by the state for the purpose of providing an independent expert opinion on the fairness of financial statements. To maintain an attitude of mental independence and objectivity in all phases of audit work, it is advisable that the CPA not fraternize with client personnel. The CPA should be courteous but reserved and dignified at all times. Indulging in social contacts with clients outside business hours will make it more difficult to be firm and objective if the CPA finds evidence of fraud or of unsound accounting practices." Ferrel replied as follows: "You are 50 years behind the times, Peters. An auditor and a client are both human beings. The auditor needs the cooperation of the client to do a good job; you're much more likely to get cooperation if you're relaxed and friendly rather than being cold and impersonal. Having a few beers or going to a football game with a client won't keep the CPA from being independent. It will make the working relationship a lot more comfortable, and will probably cause the client to recommend the CPA to other business people who need auditing services. In other words, the approach you're recommending should be called 'How to Avoid Friends and Alienate Clients.' I will admit, though, that with so many women entering public accounting and other women holding executive positions in business, a few complications may arise when auditor-client relations get pretty relaxed." Evaluate the opposing views expressed by Peters and Ferrel.

In-Class LO 1-6, 8 Team Case



- 1–41. Will Williams, a college senior, has begun the interviewing process. He has discovered a great variety of organizations in search of "accounting majors." He finds that various public accounting firms, corporations, the GAO, and the IRS are all interviewing candidates at his school. Will has come to you for advice. He has suggested that although he has had only one class session of auditing, he already realizes that it is going to be a great course; however, he also especially enjoyed his tax and accounting systems courses. Compare and contrast his possibilities with public accounting firms, corporations, the GAO, and the IRS if he wishes to emphasize the following areas of expertise:

- a. Taxation.
- b. Auditing.
- c. Systems design.

For example, first compare and contrast his likely responsibilities with each of the above organizations if he chooses to emphasize taxation.

Research and Discussion Case

LO 1-3, 8



- 1–42. Smith & Co., a local Dallas public accounting firm, is incorporated as a professional corporation, with three shareholders, all CPAs. The shareholders have developed a combination of marketing, software, and professional expertise that has allowed them to perform the accounting service of compiling individuals' personal financial statements in an extremely efficient manner. The three shareholders are interested in "going national" with their accounting service but lack the capital necessary to expand to other cities. They are currently considering the possibility of obtaining outside capital as a way to expand their business by offering their firm's services to individuals in other markets. They estimate that if they raised \$4 million of capital, they could open and staff 15 offices within the next 12 months. In a recent meeting of the three shareholders, the possibility of raising the capital through incorporation as a traditional corporation and thereby selling stock to the public was discussed. The original three shareholders would retain 51 percent of the total stock, which would be traded over the counter. The only work performed through the new corporation would be the compilation of individuals' financial statements. Subsequently, the shareholders were dismayed to learn that states do not generally allow CPAs to practice as a traditional corporation. Also, those states that do allow "limited liability companies" generally require that shareholders be involved in public accounting. Only by establishing a separate organization not held out as a public accounting firm will the current three shareholders be allowed to follow their expansion plan.
- Summarize the arguments for allowing public accounting firms to sell ownership interests to individuals not in public accounting through incorporation as a traditional corporation.
 - Summarize the arguments in favor of restricting public accounting firm ownership to those involved in public accounting.
 - Express your personal opinion as to whether ownership of public accounting firms should be restricted to individuals involved in public accounting.

Supplementary References

AICPA *Code of Professional Conduct*, Form of Organization and Name Rule (Section 1.800), pub. aicpa.org/code of conduct.

Appropriate chapters from other accounting and business textbooks that discuss the advantages of the corporate form of business.

Professional Standards

Standards are established to guide behavior and to provide criteria to measure performance of individuals and organizations. Public accounting standards that we discuss in this text address (1) engagement performance and reporting requirements (auditing, attestation, professional ethics, and other engagement standards), (2) CPA firm **quality standards**, and (3) individual CPA personal ethical standards that go beyond the requirements of (1) and (2).

Our purpose in this chapter is to make clear the general nature of these standards. This includes discussions of auditing standards, attestation standards, quality standards, and, to a limited extent, ethical standards (discussed in detail in Chapter 3). In our discussion of the auditing standards, we also consider the nature of the independent **auditors' report**—the document that emerges as the end product of an audit.

Auditing Standards

LO 2-1

Describe the authority of the two types of auditing standards in effect in the United States—AICPA generally accepted auditing standards and PCAOB auditing standards.

This chapter includes descriptions of three sets of auditing standards, including

- **AICPA *Statements on Auditing Standards*** issued by the **Auditing Standards Board (ASB)** for audits of nonpublic companies.
- **Public Company Accounting Oversight Board (PCAOB) *Auditing Standards*** issued for audits of public

companies that have securities registered with the Securities and Exchange Commission (“issuers”).

- **International Auditing and Assurance Standards Board (IAASB) *International Standards on Auditing*** (ISAs), which are infrequently used in audits performed in the United States. But, as discussed in Chapter 1, the ISA standards framework (numbering and ordering of sections of standards) has been adopted with some modification for auditing standards for nonpublic company audits. We discuss international standards in more detail later in this chapter.

In addition to the two standards-setting bodies in the United States, the boards of accountancy of the various states have the authority to regulate CPAs and CPA firms that practice within their state or jurisdiction. Figure 2.1 summarizes the regulatory authority of the PCAOB, the AICPA, and the state boards of accountancy.

In this textbook, we will focus on both the **generally accepted auditing standards (GAAS)** established by the AICPA and on PCAOB Auditing Standards. While the current AICPA standards differ somewhat from those of the PCAOB, in many areas overall auditor responsibility does not differ significantly. In areas in which there are significant differences, we will present both. In addition, Chapter 18 specifically focuses on the PCAOB’s auditing standards used on the internal control portion of the **integrated audit** required for many public companies.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 2-1** Describe the authority of the two types of auditing standards in effect in the United States—AICPA generally accepted auditing standards and PCAOB auditing standards.
- LO 2-2** Describe the nature of AICPA and PCAOB auditing standards.
- LO 2-3** Discuss the auditors’ responsibility for detecting errors, fraud, and non-compliance with laws and regulations.
- LO 2-4** Explain the primary elements of the auditors’ public and nonpublic company audit reports with unqualified (unmodified) opinions.
- LO 2-5** Describe the types of audit report modified opinions.
- LO 2-6** Describe the nature of the attestation standards.
- LO 2-7** Describe the quality management (control) standards and regulation of accounting firms.
- LO 2-8** Explain the status of international accounting and auditing standards and the content of the international audit report.
- LO 2-9** Describe the nature of audits performed in accordance with Generally Accepted Government Auditing Standards and the Single Audit Act, and of audits of employee benefit plans subject to the Employee Retirement Income Security Act of 1974.

FIGURE 2.1 Regulation of the Profession

Authority of Regulatory Bodies		
Regulatory Bodies	Integrated Audits for Public Companies	Audits for Nonpublic Companies
Public Company Accounting Oversight Board (PCAOB)	- Establishes standards* of public companies: - Auditing - Quality control - Independence - Ethical behavior - PCAOB standards have authority based on federal legislation. - Registers CPA firms to audit public companies and may revoke a firm's registration or bar an individual CPA from participating in public company audits. - Performs inspections of the public company audit practices of registered CPA firms.	No standard-setting or regulatory responsibilities regarding CPA services for nonpublic companies.
American Institute of Certified Public Accountants (AICPA)	No standard-setting or regulatory responsibilities regarding public company audits.** However, the AICPA Code of Professional Conduct does apply to AICPA members while performing public company audits.	- Establishes standards for: - Auditing - Attestation - Accounting and review (preparation, compilation, review) - Quality management - Independence - Ethical behavior - AICPA standards have authority based on their general acceptance by state boards of accountancy, other legislative organizations, and the courts. - The AICPA Peer Review Board (PRB) governs the AICPA Peer Review Program. In cooperation with state CPA societies, the PRB develops, implements, maintains, and enhances peer review standards and guidance for firms subject to peer review, those performing peer reviews, and others involved in administering its program. The PRB's National Peer Review Committee (NPRC) administers peer reviews of firms required to be registered with and subject to PCAOB inspections. - The individual membership requirements of the AICPA require members to practice in a firm that participates in a practice review program. This requirement may be met by enrollment in the AICPA Peer Review Program. - The AICPA's Private Companies Practice Section (PCPS) supports CPA firms in the everyday intricacies of running a practice. PCPS partners with firms of all sizes, creating targeted and customizable practice management resources and networking opportunities, and is a strong, collective voice within the CPA profession.
State Boards of Accountancy	- License CPAs and CPA firms to practice public accountancy in their states or jurisdictions. - In their jurisdictions, state boards have regulatory responsibility for both public and nonpublic practice. - State boards adopt AICPA and PCAOB standards but may supplement them with their own requirements.	1. License CPAs and CPA firms to practice public accountancy in their states or jurisdictions and can suspend or revoke the right to practice in those jurisdictions.

*The PCAOB adopted AICPA professional standards issued through April 16, 2003, as its interim standards. In addition, the SEC has oversight responsibility for the PCAOB and all of its standards must be approved by the SEC.

**Technically, the AICPA general ethics requirements also would apply to an AICPA member performing services for public companies.

AICPA Generally Accepted Auditing Standards

LO 2-2

Describe the nature of AICPA and PCAOB auditing standards.

The AICPA's Auditing Standards Board (ASB) issues auditing standards in the form of *Clarified Statements on Auditing Standards* (SASs) following a process that includes deliberations in meetings open to the public, public exposure of proposed SASs, and a formal vote.

The standards are identified under two numbering systems: the SAS number and an AU-C number. The SAS numbering system organizes SASs by date of issue, whereas the AU-C numbering system organizes them by topic.¹ Throughout this textbook, we will make reference to the AICPA Auditing Standards Board's section (e.g., AICPA AU-C 230). Because the PCAOB standards have different references, we will also provide the PCAOB section (e.g., PCAOB AS 1215).

Underlying Principles

The AICPA Auditing Standards Board standards are structured around the set of principles presented in Figure 2.2. These principles provide a summary of the information discussed throughout the *Professional Standards* and this text. They make clear that the purpose of an audit is to provide an opinion on the financial statements, with an underlying premise that management is responsible both for preparing financial statements in accordance with the **applicable financial reporting framework** and for providing the auditors with access to necessary information. As discussed in Chapter 1, a financial reporting framework is a set of criteria used to prepare the financial statements; in the United States, the financial reporting framework most frequently used is generally accepted accounting principles promulgated by the Financial Accounting Standards Board (FASB).² Such a framework is necessary in an audit because the auditors' report provides assurance on whether the financial statements follow that framework.

Auditors have a personal responsibility to have appropriate competence, comply with ethical requirements, and maintain professional skepticism and exercise professional judgment. **Professional skepticism** includes a questioning mind, being alert to conditions that may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence. Professional standards requires that, throughout the audit, the auditors maintain professional skepticism and be alert for



- Audit evidence that contradicts other audit evidence.
- Information that raises a question about the reliability of documents and responses to inquiries, including potential bias of the source of the information.
- Conditions indicating possible fraud.
- Circumstances suggesting the need for additional audit procedures beyond those ordinarily required.

¹ In 2011, to improve the clarity of its auditing standards and to converge them with the international standards to the extent considered desirable, the Auditing Standards Board revised its auditing standards to make them easier to read, understand, and apply. For example, the current standards now more clearly state the objectives of each specific section and highlight the requirements with which the auditor must comply. Because the previous standards used the prefix "AU," to distinguish the clarity standards the prefix "AU-C" was selected. Subsequently, attestation standards and accounting and review standards were revised and now also contain the "-C," which may be considered either as "clarified" or "clarity."

² Financial reporting frameworks may differ on several dimensions. First, a financial reporting framework may be viewed as being either a *fair presentation framework* or a *compliance framework*. A fair presentation framework (1) includes compliance with its requirements and acknowledges explicitly or implicitly that management may need to provide disclosures beyond those specifically required by the framework or (2) explicitly states that it may be necessary for management to depart from a requirement of the framework to achieve fair presentation in rare circumstances. A compliance framework only requires that the preparer comply with specific disclosure requirements. While the International Auditing Standards provide both types, GAAS only address fair presentation frameworks because they are believed to be the only frameworks used in the United States.

Financial reporting frameworks also differ in that a framework may be either a general-purpose financial reporting framework (most frequently, generally accepted accounting principles, but also International Accounting Standards) or a special-purpose financial reporting framework (e.g., cash or tax basis financial statements—discussed further in Chapter 19).

FIGURE 2.2 Principles Underlying an Audit Conducted in Accordance with Generally Accepted Auditing Standards*

Purpose of an Audit	The purpose of an audit is to provide financial statement users with an opinion by the auditor on whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework. An auditor's opinion enhances the degree of confidence that intended users can place in the financial statements.
Premise of an Audit	An audit in accordance with generally accepted auditing standards is conducted on the premise that management and, when appropriate, those charged with governance, have responsibility - For the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error. - To provide the auditor with - All information, such as records, documentation, and other matters that are relevant to the preparation and fair presentation of the financial statements. - Any additional information that the auditor may request from management and, where appropriate, those charged with governance. - Unrestricted access to those within the entity from whom the auditor determines it necessary to obtain audit evidence.
Personal Responsibilities of the Auditor	Auditors are responsible for having <i>appropriate competence and capabilities</i> to perform the audit; complying with relevant ethical requirements; and exercising professional skepticism and professional judgment throughout the planning and performance of the audit.
Auditor Actions in Performing the Audit	To <i>express an opinion</i>, the auditor obtains reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. To <i>obtain reasonable assurance</i>, which is a high, but not absolute, level of assurance, the auditor - Plans the work and properly supervises any assistants. - Determines and applies appropriate materiality level or levels throughout the audit. - Identifies and assesses risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control. - Obtains sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks. The auditor is <i>unable to obtain absolute assurance</i> that the financial statements are free from material misstatement because of inherent limitations, which arise from - The nature of financial reporting. - The nature of audit procedures. - The need for the audit to be conducted within a reasonable period of time in order to achieve a balance between benefit and cost.
Reporting Results of an Audit	Based on an evaluation of the audit evidence obtained, the auditor expresses, in the form of a written report, <i>an opinion in accordance with the auditor's findings, or states that an opinion cannot be expressed</i> . The opinion states whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

*AU-C .02, Preface AICPA Auditing Standards

Finally, the auditors' work results in them being able to obtain *reasonable, not absolute, assurance* that the financial statements follow the applicable financial reporting framework. **Reasonable assurance** implies that there is a low level of risk remaining that the auditors express an opinion that the financial statements are properly stated when they are not. Obtaining absolute assurance is not possible due to (1) the nature of financial reporting (e.g., the necessary use of judgment), (2) the nature of audit procedures (e.g., they often do not provide absolutely conclusive evidence), and



Illustrative Case

Impediments to Professional Skepticism

Oversight activities conducted by its staff have led the PCAOB to raise concerns about whether auditors consistently and diligently apply professional skepticism. They suggest that inherent conditions in the audit environment can create incentives and pressures that impede the application of professional skepticism. Examples include incentives and pressures to

- Build or maintain a long-term audit engagement.
- Complete the audit too quickly to meet client or firm demands.

- Achieve high client satisfaction ratings.
- Keep audit costs low.
- Cross-sell other services.

In addition, the PCAOB suggests that auditors may sometimes develop an inappropriate level of trust or confidence in management.

(3) the need to conduct an audit within a reasonable period of time and at a reasonable cost. Accordingly, the auditors express an opinion on the financial statements, not a statement of fact.

Critical to the profession is the need for **independence** when performing audits (and other assurance services). An opinion by CPAs as to the fairness of a company's financial statements (or other information) is of questionable value unless they are truly independent. Indeed, if auditors own shares of stock in a company that they audit, or if they serve as members of the board of directors, they might subconsciously be biased in the performance of auditing duties. The auditors therefore should avoid any relationship with a client that would cause an outsider who had knowledge of all the facts to doubt their independence. It is not enough that auditors *be* independent; they must conduct themselves in such a manner that informed members of the public will have no reason to doubt their independence. That is why the public accounting profession's ethical standards include independence requirements; these requirements are discussed in detail in Chapter 3.

Details Related to AICPA Guidance

The *Clarified Statements on Auditing Standards (SASs)* provide a variety of specific auditing requirements and guidance to be considered by auditors. *SASs* ordinarily include the following sections:

- Introduction, including scope.
- Objective(s).
- Definitions of important terms.
- Requirements.
- Application and other explanatory material.

The exact wording of auditor responsibilities in the *Clarified Statements on Auditing Standards*, particularly in the Requirements section, is important. For example, some audit requirements apply under all circumstances (referred to as an “unconditional responsibility”), while others are required unless the auditors can show that alternative actions are sufficient (“presumptively mandatory responsibility”). Alternatively, some areas are left entirely to the auditor's judgment. Figure 2.3 provides responsibility levels, meanings, and the words that indicate those levels.

In addition to the *Statements on Auditing Standards*, the AICPA has issued a variety of more detailed, but less authoritative guidance. Figure 2.4 summarizes all AICPA guidance, structured as the Generally Accepted Auditing Standards Hierarchy.

FIGURE 2.3

Professional Responsibilities: Terminology Used in Auditing Standards: PCAOB (Rule 3101) and Auditing Standards Board (AU-C 200) Combined

Responsibility Level	Meaning	Words Used to Indicate Responsibility
Unconditional Responsibility	Auditor must comply with requirement in all cases where the requirement is relevant.*	“Must” “Shall” (PCAOB only) “Is required” (PCAOB only)
Presumptively Mandatory Responsibility	Auditor must comply with requirement in all cases in which the requirement is relevant, except in rare circumstances when the auditor makes a judgment that it is necessary to depart from the standard.	“Should”
Responsibility to Consider (this third level of responsibility is only established in PCAOB documents)	Auditor should consider; whether the auditor follows depends on exercise of professional judgment in the circumstances.	“May” “Might” “Could” Other phrases indicating a responsibility to consider

*Example of when a requirement is not relevant: If the client does not have an internal audit function, the standard titled “Using the Work of Internal Auditors” would not apply.

FIGURE 2.4

GAAS Hierarchy

Category	Status	Audit Guidance
1. Standards	Basically must be applied, but also consider the Figure 2.3 responsibility levels (e.g., unconditional v. presumptively mandatory).	<i>Statements on Auditing Standards (SASs)</i> Other standards that apply for PCAOB and government audits, etc.
2. Interpretive Publications*	Recommendations on the application of SASs; the auditor should consider them.	Auditing interpretations of GAAS Audit guidance in <i>AICPA Audit and Accounting Guides</i> <i>AICPA Statements of Position—Auditing and Attestation</i>
3. Other Auditing Publications	No authoritative status but may help the auditor understand and apply the standards.	Various AICPA publications, including <i>Auditing Practice Releases</i> , <i>Technical Practice Aids</i> , <i>Audit Risk Alerts</i> , <i>Professional Issues Task Force Practice Alerts</i> , and other publications Auditing articles in <i>Journal of Accountancy</i> and other professional journals Others (e.g., continuing education program materials, textbooks, guidebooks, audit programs)

*These are documents issued under authority of the Auditing Standards Board after all its members have been provided an opportunity to comment.

PCAOB Auditing Standards

The PCAOB adopted the existing AICPA auditing standards as of April 16, 2003, as its interim standards. Following that adoption, the PCAOB began issuing its own series of *Auditing Standards*. Until 2015, the PCAOB standards were a combination of its own series and those AICPA standards (often modified by the PCAOB’s own standards). In 2015, the PCAOB reorganized the combination of interim standards and its *Auditing Standards* into an overall framework; that reorganization became effective on December 31, 2016. The framework, presented in detail in the Appendix at the back of this text, includes the following broad categories:

- General Auditing Standards.
- Audit Procedures.
- Auditor Reporting.
- Matters Relating to Filings under Federal Securities Laws.
- Other Matters Associated with Audits.

The various subsections under each of the broad categories begin with the prefix AS (for Auditing Standard). For example, AS 1001 under General Auditing Standards addresses responsibilities and functions of the independent auditor. Recall that PCAOB standards apply to audits of public companies and that in many areas they do not differ significantly from AICPA standards. Throughout the text, we emphasize areas of major differences between PCAOB and AICPA standards.

The Auditors' Responsibility for Detecting Misstatements

LO 2-3

Discuss the auditors' responsibility for detecting errors, fraud, and noncompliance with laws and regulations.

As indicated earlier in this chapter, the auditors have a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.³ Reasonable assurance is achieved when **audit risk**, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated, is at an acceptably low level. Financial statements may be misstated due to various causes, including errors, fraud, and noncompliance with certain laws and regulations.

Errors and Fraud



Auditing standards define **errors** as unintentional misstatements or omissions of amounts or disclosures in the financial statements. Errors may involve mistakes in gathering or processing data, unreasonable accounting estimates arising from overlooked or misinterpreted information, or mistakes in the application of applicable accounting principles.

Fraud, as the term is used in financial statement auditing (AICPA AU-C 240; PCAOB AS 2401), relates to *intentional* acts that cause a misstatement of the financial statements. Misstatements due to fraud may occur due to either (1) fraudulent financial reporting or (2) misappropriation of assets.

During the planning of an audit, the auditors are required to assess the risk of material misstatements—whether caused by error or fraud. Based on that assessment, they plan and perform their audit to obtain reasonable assurance of detecting such misstatements. To obtain reasonable assurance, the auditors should exercise due care in planning, performing, and evaluating the results of their audit procedures. This requires auditors to exercise professional skepticism. As indicated earlier in this chapter, professional skepticism involves having a questioning mind and a critical assessment of audit evidence throughout the audit process.

The concept of fraud provides a good illustration of why an audit can provide reasonable, but not absolute, assurance of detecting material misstatement of the financial statements. Fraud is often difficult to detect because it may involve concealment schemes such as forgery, deliberate failure to record transactions, or intentional misrepresentations made to the auditors. When accompanied by collusion among several employees, the concealment may make the fraud very difficult to detect. Also, when that fraud involves management, it may be more difficult to detect than employee fraud because management is often in a position to manipulate accounting records and to override control procedures. Indeed, the risk of not detecting a material misstatement resulting from fraud is ordinarily higher than the risk of not detecting one resulting from error.

Compliance with Laws and Regulations

The auditors' responsibility for identifying client noncompliance with laws and regulations (hereafter, laws) depends upon the nature of the law or regulation. The *Professional Standards* identify two types of laws and regulation: those with a direct effect on the financial statement amounts and other laws.

Direct effect laws have a *direct effect* on the financial statements in that they determine the reported amounts or disclosures in those statements. Noncompliance with these laws often results in the need for accounting journal entries. Examples include laws that affect the accounting for transactions under government contracts and laws and regulations that affect the accrual of taxes. Other laws do not have a direct effect in the determination of

³ The professional standards on planning and performing the audit address the overall risks of material misstatement (AICPA AU-C 315; PCAOB AS 2110) and considering fraud (AICPA AU-C 240; PCAOB AS 2401).

amounts and related disclosures, but compliance with them is required to stay in business, or to avoid financial penalties. Examples of these laws include corporate business laws, environmental laws and regulations, and antitrust laws. In this text, we will refer to the former as *laws with a direct effect* and the latter as *other laws*. The difference between them is important because auditors have a higher level of responsibility for detecting violations of laws with a material direct effect.

As explained in auditing standards (AICPA AU-C 250; PCAOB AS 2405), the auditors should obtain an understanding of the legal and regulatory framework applicable to the entity and how the organization complies with that framework. For laws with a direct effect, the auditors should gather sufficient appropriate audit evidence to obtain reasonable assurance of detecting material misstatements resulting from noncompliance—this is the same responsibility the auditors have for material errors and fraud.

Other laws relate primarily to the operating aspects of the company and do not directly affect financial statement amounts (their financial statement effect is indirect). Examples may include laws and regulations on securities trading, occupational safety and health, environmental protection, and equal employment. Their indirect effect may result from the need to disclose a contingent liability because of noncompliance with a law.

The auditors are not required to perform sufficient procedures to obtain reasonable assurance of detecting violations of these other laws. However, they are required to perform specified audit procedures that may identify instances of noncompliance, including

- Inquiring of management and those charged with governance as to whether the entity is in compliance with such laws.
- Inspecting correspondence, if any, with relevant licensing or regulatory authorities.

Also, throughout the audit the auditors should remain alert for indications of noncompliance or suspected noncompliance with any laws that may arise from performing other audit procedures.

Additional audit procedures are required when evidence of noncompliance is identified or suspected. In such situations, the auditors should obtain (1) an understanding of the act and the circumstances in which it has occurred, and (2), further information to evaluate the possible effect on the financial statements. They also should advise the client to take appropriate actions to rectify or remediate the noncompliance and, where appropriate, disclose the matter to an authority where required by law or regulation. If the auditors determine that management's response was not appropriate, they are required to consider withdrawing from the engagement, unless prohibited by law or regulation.

If the auditors identify actual or suspected instances of noncompliance, they should communicate the matters to those charged with governance of the organization (e.g., the audit committee of the board of directors), unless the matters are clearly inconsequential. When the violations are considered intentional and material, the auditors should communicate the matter to those charged with governance as soon as practicable.

If the auditors suspect that management or those charged with governance are involved in noncompliance, they should communicate the matter to the next higher level of authority in the organization, if it exists. Where no higher authority exists that is uninvolved, or if the auditors believe that the communication may not be acted upon, they should consider the need to obtain legal advice.⁴

⁴ The Private Securities Litigation Reform Act of 1995 places additional requirements upon public companies registered with the Securities and Exchange Commission and their auditors when (1) the illegal act has a material effect on the financial statements, (2) senior management and the board of directors have not taken appropriate remedial actions, and (3) the failure to take remedial action is reasonably expected to warrant departure from a standard audit report (or to warrant resignation). In such circumstances, the auditors "shall, as soon as practicable," communicate their conclusions directly to the board of directors. Within one day, the company must notify the Securities and Exchange Commission of having received such a communication and must send a copy of that notification to the auditors. If the auditors do not receive such notice within the one-day period, they must furnish the report to the SEC within one business day after the failure of the company to give the required notice.

Auditors' Reports

LO 2-4

Explain the primary elements of the auditors' public and nonpublic company audit reports with unqualified (unmodified) opinions.

The end product of an audit of a business entity is a report expressing the auditors' opinion on the client's financial statements. The form of auditors' report discussed in detail in the following two sections is one in which the auditors provide an opinion that the financial statements follow generally accepted accounting principles and raise no other issues or concerns. The opinion is referred to as "unqualified" in the PCAOB standards and as "unmodified" in the AICPA standards.⁵ It indicates that the audit was adequate in scope and that the financial statements present fairly the financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. Under these circumstances, the auditors are taking *no exceptions* and inserting *no modifications or qualifications* in the report.

The content of the auditors' report varies depending on whether it results from the audit of a public or nonpublic company. We first present the audit report for a public company, followed by the report for a nonpublic company.

Public Company Audit Reports—Unqualified Opinion

As discussed in Chapter 1, the Sarbanes–Oxley Act requires that auditors of large publicly traded (issuer) companies in the United States perform an integrated audit that includes providing assurance on both the financial statements and the effectiveness of internal control over financial reporting. In these audits, the auditors may either issue separate reports on the financial statements and internal control or issue a combined report. The following is a separate report on the financial statements of a publicly traded company.⁶

Report of Independent Registered Public Accounting Firm

To the Shareholders and the Board of Directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X7 and 20X6, the related statements of income, comprehensive income, stockholders' equity, and cash flows, for each of the three years in the period ended December 31, 20X7, and the related notes [and schedules] (collectively referred to as the "financial statements"). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 20X7 and 20X6, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X7, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the Company's internal control over financial reporting as of December 31, 20X7, based on *Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)* and our report dated February 12, 20X8, expressed an unqualified opinion.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

⁵ The term "unmodified" is included in the current AICPA standards; historically, the term "unqualified" has been used. The term "unqualified" is still used in PCAOB standards. We will consider the two terms as synonymous but will ordinarily use the term "unmodified" when discussing nonpublic company audits. Also, because the standards present multiple-year reports as examples, we also present them—if only one year is audited, the report should be modified accordingly. Also historically, these reports have been referred to as **standard reports**, a term not currently used by either the PCAOB or the AICPA.

⁶ Because public companies are ordinarily required to provide balance sheets for the two most recent years, and statements of income, retained earnings, and cash flows for three years, we present an audit report on such comparative financial statements.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matters [if applicable]

The critical audit matters communicated below are matters arising from the current period audit of the financial statements that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

[Include critical audit matters]

Los Angeles, California
February 12, 20X8

Blue, Gray & Company
Certified Public Accountants

We have served as the Company's auditor since 20X0.

The title of the auditor's report for a public company (per AS 3101) must include the words "Report of the Independent Registered Public Accounting Firm." In addition, it must be addressed to the shareholders and board of directors (or equivalents), although additional addressees may be added. In the following paragraphs, we provide detailed discussions of each of the sections of the report.

Opinion on the Financial Statements

The Opinion section of the auditor's report begins by stating that an audit of the specified financial statements was performed and then provides the auditor's opinion. When the auditors have also performed an audit of the client's internal control over financial reporting, either a combined audit report on the financial statements and internal control or separate audit reports may be issued. Since this is an example of separate reports, the first paragraph provides the opinion on the financial statements and the second refers to the auditor's separate report on internal control over financial reporting. The first paragraph is restated below to highlight two significant concepts shown in boldface italics:

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X7 and 20X6, the related statements of income, comprehensive income, stockholders' equity, and cash flows, for each of the three years in the period ended December 31, 20X7, and the related notes [and schedules] (collectively referred to as the "financial statements"). ***In our opinion***, the financial statements present fairly, in all ***material*** respects, the financial position of the Company as of December 31, 20X7 and 20X6, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X7, in conformity with accounting principles generally accepted in the United States of America.

The two highlighted phrases have special significance. The first, "in our opinion," makes clear that the auditors are expressing an informed opinion, but are not guaranteeing or certifying that the statements are accurate, correct, or true. In an earlier period of public accounting, the wording of the audit report contained the phrase "we certify that,"

but this expression was discontinued on the grounds that it was misleading. To “certify” implies absolute assurance of accuracy, which an audit does not provide.

The auditors cannot guarantee the correctness of the financial statements because the statements include many estimates, not absolute facts. Furthermore, the auditors do not make a complete and detailed examination of all transactions. Their audit is limited to tests that leave the possibility of some misstatements going undetected. Because of limitations inherent in the accounting process and because of practical limitations of time and cost in performing an audit, the auditors’ work culminates in the expression of an opinion and not in the issuance of a guarantee of accuracy.

What Is “Material”? Auditors cannot issue an unqualified opinion on financial statements that contain material deficiencies of which they are aware. But what makes a deficiency “material”? The FASB states (*italics added*) “the omission of an item in a financial report is material if, in light of surrounding circumstances, the *magnitude* of the item is such that it is *probable that the judgment of a reasonable person relying upon the report would have been changed or influenced* by the inclusion or correction of the item.” As we discuss further in Chapter 6, the AICPA and PCAOB have similar definitions.

Materiality differs by entity. In the audit of a small corporation, \$500,000 might be considered material. On the other hand, in the audit of a company such as Apple, an amount of \$50 million might be considered immaterial.

In practice, one of the most significant elements of professional judgment is the ability to draw the line between material and immaterial departures from generally accepted accounting principles. The auditor who raises objections over immaterial items will soon lose the respect of both clients and associates. On the other hand, the auditor who fails to identify and disclose material deficiencies in financial statements may be liable for the losses of those who rely upon the audited statements. In short, applying the concept of materiality is one of the most complex problems faced by auditors. Materiality is discussed in further detail in Chapter 6.

Basis for Opinion

The Basis for Opinion section describes the responsibilities of both management and the auditors and the nature of an audit performed in accordance with PCAOB standards. It also alludes to the requirements of registration and independence in accordance with SEC regulations and PCAOB rules. The section concludes with a statement that the auditors believe that their audits provide a reasonable basis for their opinion.

Management’s Responsibility Management is responsible for the financial statements. It has the responsibility of maintaining adequate internal control and of preparing proper financial statements for the use of stockholders and other parties. Because the financial statements are the responsibility of company management and not the auditors, the auditors have no right or authority to make changes to the financial statements, even if those changes would bring the statements into conformity with generally accepted accounting principles. What action then should the auditors take if they do not agree with the presentation of a material item in the balance sheet or income statement?⁷ Assume, for example, that the auditors believe that the balance in the allowance for uncollectible accounts is not sufficient to cover the probable collection losses in the accounts receivable.

The auditors will first discuss the problem with management and point out why they believe that the valuation allowance is inadequate. If management agrees to increase the balance, an adjusting entry will be made for that purpose, and the problem is solved. If management is not convinced by the auditors’ arguments and declines to increase the allowance, the auditors will probably *qualify* their opinion by stating in the report that the financial statements reflect fairly the company’s financial position and operating

⁷ The balance sheet and income statements are sometimes titled the statement of financial position and the statement of operations, respectively.

results, *except for the effects of not providing an adequate provision for uncollectible accounts*. Alternatively, if the misstatement is considered material and pervasive, an adverse opinion is appropriate. Usually such issues are satisfactorily resolved in discussions between the auditors and management, and a modification of the auditors' opinion is avoided. Also, as a practical matter, the difference will be resolved as the SEC does not ordinarily accept such modified opinions in regulatory filings. Audit report opinion modifications are presented in detail in Chapter 17.

The Auditors' Responsibility The auditors' responsibility is to express an opinion on the financial statements based on having conducted an audit following standards of the PCAOB. Underlying this opinion is the auditors' belief that they have obtained reasonable assurance that the financial statements are free of material misstatement. To obtain reasonable assurance, they obtain audit evidence by performing various audit procedures. Examples of audit evidence obtained include analysis of the client's financial records, observation of tangible assets, inspection of such documents as purchase invoices and contracts, and the gathering of evidence from outsiders (such as banks, customers, and suppliers). Because of the variety of types of evidence obtained, it is appropriate that the auditors state in their report that they have audited *the financial statements* rather than to say that they have audited the accounting records. In the illustration, the auditors' report covers the years for which financial statements were presented by the company. Reporting on such comparative financial statements is discussed in detail in Chapter 17.

Critical Audit Matters

Effective in 2019 (for large public companies) and 2020 (for other public companies), the PCAOB required auditors to present in their reports "Critical Audit Matters." **Critical audit matters** are those that relate to financial statement accounts or disclosures and involved especially challenging, subjective, or complex auditor judgment. The disclosure of critical audit matters in audit reports is discussed in detail in Chapter 17.

Signature, Auditor Tenure, Location, and Audit Report Date

The report on the financial statements of a public company should be dated no earlier than the date that the auditors have obtained sufficient appropriate evidence to support their opinion. The report should be signed in the name of the firm with the city and state of the CPA firm office that issued the report. Finally, it should include a statement of when the firm began serving as the corporation's auditor (auditor tenure).

Nonpublic Company Audit Reports— Unmodified Opinion

The auditors' report for a nonpublic company is similar in content to the report for a public company, but it differs in organization and details. The nonpublic company report begins with a title that includes the word "independent" and is addressed to those for whom the report is prepared. In the case of a corporation, the report is often addressed to the corporation, the audit committee, or its shareholders. Recall that the public company audit report indicates that the audit was conducted in accordance with the standards of the PCAOB; the nonpublic company audit report indicates that the audit was conducted in accordance with auditing standards generally accepted in the United States of America.⁸ In its most basic form, the nonpublic company audit report consists of sections on (1) the auditor's opinion, (2) the basis for that opinion, (3) management responsibility, and (4) auditor responsibility. Recall that management and auditor responsibility are included in the Basis for Opinion section in the public company report.

⁸ Historically, *audit* reports referred simply to generally accepted auditing standards and generally accepted accounting principles. The globalization of business resulted in a modification of the standard report that identifies the source of the standards followed (e.g., International, United States [of America], PCAOB, or some other country's standards). In this text, we will use the new terminology in report illustrations, but, like the standards, we will refer to generally accepted auditing standards (GAAS) and generally accepted accounting principles (GAAP) in other contexts.

In addition, as is discussed further in Chapter 17, a nonpublic company audit report with an unmodified opinion will also include:

- An **Other Information** section when the financial statements are included in an annual report with other information (e.g., management report, financial summaries) and
- A **Key Audit Matters (KAMs)** section (a concept similar to the critical audit matters in public company reports) when the terms of the engagement call for one.

Similar to the report for public companies, the nonpublic company audit report should be dated no earlier than the date the auditors have gathered sufficient appropriate evidence to support their opinion, and it should be signed in the name of the firm, including its city and state. However, unlike the report for public companies, the year the firm began serving as the company's auditor need not be disclosed.

The following is a nonpublic company audit report with an unmodified opinion.

Independent Auditor's Report

To the Audit Committee of ABC Company
17 E. Main, Phoenix, AZ 85011:

Opinion

We have audited the financial statements of ABC Company, which comprise the balance sheets as of December 31, 20X1 and 20X0, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1 and 20X0, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Basis for Opinion

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of ABC Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company's ability to continue as a going concern for one year subsequent to issuance of these financial statements.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.

In performing an audit in accordance with GAAS, we

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of ABC Company's internal control. Accordingly, no such opinion is expressed.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit.

Williams & Co. LLP
Phoenix, Arizona
February 5, 20X2

As we will discuss in further detail in Chapter 17, in certain circumstances, information may be added to what remains a report with an unmodified opinion. For example, audit reports are modified to inform users of financial statements of a lack of **consistency** in the application of accounting principles in relation to the prior year, or the fact that another audit firm is responsible for a significant portion of the audit. Thus, while the auditors' opinion is unmodified (unqualified), the report draws the reader's attention to the matter.

Generally Accepted Accounting Principles (GAAP)

In audits of both public and nonpublic companies, the fairness of the financial statements is judged against an appropriate applicable financial reporting framework. Most frequently, in the United States, this framework is "accounting principles generally accepted in the United States of America." Since they have general applicability, such standards are referred to as a **general-purpose financial reporting framework**. In evaluating whether a particular accounting principle used by a client is generally accepted, the auditors may refer to the standards of the Financial Accounting Standards Board (for public and nonpublic nongovernmental companies), the Government Accounting Standards Board (for state and local government entities), and the Federal Accounting Standards Advisory Board (for federal government audits), as well as a variety of other sources.

The accounting guidance for both public and nonpublic entities has only two levels: (1) authoritative GAAP and (2) nonauthoritative accounting guidance and literature. The *FASB Codification* is the source of authoritative GAAP to be applied by nongovernmental entities (businesses and not-for-profit entities). The codification is updated through *Accounting Standards Updates*. The rules and interpretive releases of the Securities and Exchange Commission under the federal securities laws are also sources of authoritative GAAP for public companies. If the guidance for a transaction or event is not specified within the authoritative GAAP or SEC guidance, the company should first consider accounting principles for similar transactions or events in authoritative GAAP. Finally, when no other guidance can be found, nonauthoritative accounting guidance should be consulted. Sources of nonauthoritative accounting guidance and literature include

- Practices that are widely recognized and prevalent either generally or in the industry.
- FASB Concepts Statements.
- AICPA Issues Papers.
- International Financial Reporting Standards.
- Pronouncements of professional associations or regulatory agencies.
- Technical Information Service Inquiries and Replies included in AICPA.
- Technical Practice Aids.
- Accounting textbooks, handbooks, and articles.

The appropriateness of the above nonauthoritative accounting guidance and literature depends on its relevance to particular circumstances, how specific it is, the general recognition of the issuer or author as an authority, and the extent of its use in practice. It also should be recognized that adherence to generally accepted accounting principles includes **adequate disclosure** of all essential information. Adequate disclosure means the information is accurate and complete and has been clearly conveyed to the financial statement user.

Figure 2.5 illustrates the hierarchy of guidance for state and local governmental entities and federal government audits. When there is a conflict between the accounting treatment suggested by pronouncements from two different categories, the pronouncement from the higher category should be followed. For example, authoritative body pronouncements prevail over pronouncements of other experts and widely recognized practices and pronouncements. When there is a conflict within a category, logic dictates that the auditors should select the accounting principle that most clearly reflects the *economic substance* of the particular transaction.

FIGURE 2.5 The GAAP Hierarchy for Governmental Entities

Category	State and Local Governments*	Federal Government**
a. Authoritative Body Pronouncements	• GASB <i>Statements and Interpretations</i> • FASB and AICPA pronouncements made applicable by a GASB <i>Statement or Interpretation</i>	• FASB <i>Statements and Interpretations</i> • AICPA, FASB, and GASB pronouncements made applicable by an FASAB <i>Statement or Interpretation</i>
b. Pronouncements of Bodies Composed of Expert Accountants, Exposed for Public Comment	• GASB <i>Technical Bulletins</i> • AICPA <i>Industry Audit and Accounting Guides and Statements of Position</i> (cleared by GASB)	• FASAB <i>Technical Bulletins</i> • AICPA <i>Industry Audit and Accounting Guides and Statements of Position</i> (cleared by FASAB)
c. Pronouncements of Bodies Composed of Expert Accountants, Not Exposed for Public Comment	• <i>Consensus Positions of the GASB Emerging Issues Task Force</i> • AICPA <i>Practice Bulletins</i> (cleared by GASB)	• <i>Technical Releases</i> of the Accounting and Auditing Policy Committee of the FASAB • AICPA <i>Practice Bulletins</i> (cleared by the FASAB)
d. Widely Recognized Practices and Pronouncements	• GASB staff “Questions and Answers” • Widely accepted industry practices	• FASAB staff <i>Implementation Guides</i> • Widely accepted federal government practices
e. Other Accounting Literature	• GASB <i>Concepts Statements</i> • Pronouncements in (a) through (d) of nongovernmental hierarchy not specifically made applicable • APB <i>Statements</i> • FASB <i>Concepts Statements</i> • AICPA <i>Issues Papers and Technical Practice Aids</i> • International Accounting Standards Committee <i>Statements</i> • Pronouncements of other professional associations or regulatory agencies • Accounting textbooks, handbooks, and articles	• FASAB <i>Concepts Statements</i> • Pronouncements in (a) through (d) of GASB and FASB not specifically made applicable • FASB and GASB <i>Concepts Statements</i> • AICPA <i>Issues Papers and Technical Practice Aids</i> • International Accounting Standards Committee <i>Statements</i> • Pronouncements of other professional associations or regulatory agencies • Accounting textbooks, handbooks, and articles

*Government Accounting Standards Board Statement No. 55, “The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments.”

**Statement of Federal Financial Accounting Standards 34, “The Hierarchy of Generally Accepted Accounting Principles. Including the Application of Standards Issued by the Financial Accounting Standards Board.”

Auditors' Reports with Modified Opinions

LO 2-5

Describe the types of audit report modified opinions.

A report with an *unmodified* (“unqualified” per PCAOB standards) opinion is the type of report the client ordinarily wants. In some audits, however, the circumstances require auditors to issue an audit report with a modified opinion on the financial statements. Reports with modified opinions include those with a *qualified opinion*, an *adverse opinion*, or a *disclaimer of opinion*. In some situations, auditors also include additional information in a report with an unmodified opinion.

A **qualified opinion** on financial statements states that *except for* the effects of the matter to which the qualification relates, the financial statements are fairly presented. That matter may be due to a limitation on the scope of the audit, or due to one or more items in the financial statements that are not presented in accordance with applicable accounting principles. The limitation on scope must be significant, but not so significant as to overshadow an overall opinion on the financial statements; the departure from applicable accounting principles also must be material, but not so material as to pervasively misstate the financial statements.

An **adverse opinion** states that the financial statements *are not fairly presented*. In practice, an adverse opinion is rare because it would be of little use to the client. If the financial statements contain such material departures from applicable accounting principles as to warrant an adverse opinion, the situation is discussed among the auditors and the client’s management. Management probably will agree to make the changes necessary to avoid an adverse opinion or will decide to terminate the audit engagement and thus avoid paying additional audit fees.

Auditors will issue a **disclaimer of opinion** if they are unable to determine the overall fairness of the financial statements. This type of report most frequently results from very significant limitations in the scope of the auditors’ examination.⁹

When a qualified, adverse, or disclaimer of opinion is issued on the financial statements, the report is modified to describe the matter of concern.

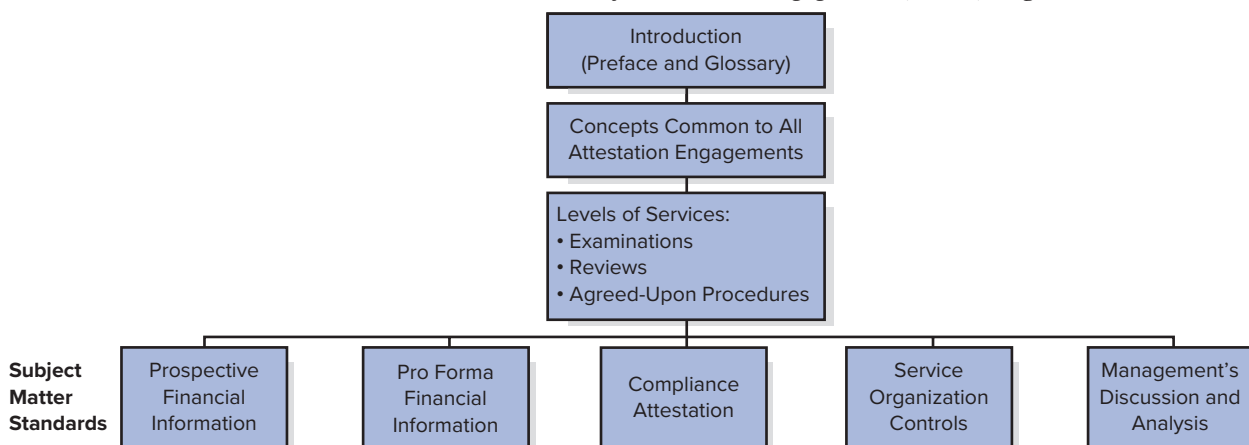
The Attestation Standards

LO 2-6

Describe the nature of the attestation standards.

The AICPA’s generally accepted auditing standards provide guidance for the audit of non-public company historical financial statements or for an integrated audit (an audit of both the financial statements and internal control over financial reporting). The expansion of the attest function to additional areas led the accounting profession to develop standards for attestation to various other types of information; those standards are included in the series of *Clarified Statements on Standards for Attestation Services (AT-C)*. Figure 2.6 summarizes

FIGURE 2.6 AICPA Clarified Statements on Standards for Attestation Engagements (SSAEs) Organization



⁹ As is discussed in Chapter 17, disclaimers of opinion may also be issued in additional circumstances, including going concern and other uncertainties, or a lack of auditor independence.

the organization of the current AICPA attestation standards. Notice that, as is discussed in Chapter 1, three levels of services have been available: examinations, reviews, and agreed-upon (selected) procedures engagements. The figure also shows that standards have been developed for providing attestation services for financial forecasts and projections, pro forma financial information, compliance attestation, service organization controls, and management discussion and analysis. Details on these services are presented in Chapter 20.

As is the case with the AICPA's auditing standards, the PCAOB adopted the AICPA's Attestation Standards in existence April 16, 2003. Most of those standards remain in the PCAOB standards with certain updating. Those standards are structured about the 11 Attestation Standards presented in Figure 2.7. The AICPA's clarified attestation standards, which apply to engagements with nonpublic companies, do not explicitly include Figure 2.7's list.

FIGURE 2.7
PCAOB Attestation
Standards*

General Standards

1. The engagement shall be performed by a practitioner having *adequate technical training and proficiency in the attest function*.
2. The engagement shall be performed by a practitioner having *adequate knowledge in the subject matter*.
3. The practitioner shall perform the engagement only if he or she has reason to believe that the *subject matter is capable of evaluation or measurement* against criteria (standards or benchmarks) that are suitable and available to users.
4. In all matters relating to the engagement, an *independence* in mental attitude shall be maintained by the practitioner.
5. *Due professional care* shall be exercised in the planning and the performance of the engagement.

Standards of Fieldwork

1. The work shall be *adequately planned* and assistants, if any, shall be properly *supervised*.
2. *Sufficient evidence* shall be obtained to provide a reasonable basis for the conclusion that is expressed in the report.

Standards of Reporting

1. The report shall *identify the subject matter* or the assertion being reported on and state the *character of the engagement*.
2. The report shall state the *practitioner's conclusion* about the subject matter or the assertion based on the criteria against which the subject matter was measured.
3. The report shall state all of the practitioner's *significant reservations* about the engagement.
4. The report on an engagement to evaluate subject matter that has been prepared based on *agreed-upon criteria* or an assertion related thereto, or on an engagement to apply *agreed-upon procedures*, should contain a statement *restricting its use* to the parties who have agreed upon such criteria or procedures.

*These standards were adopted by the PCAOB (see AT Section 101) from AICPA standards in existence on April 16, 2003. Currently, although these 11 standards are largely consistent with the current clarified AICPA Attestation Standards, they are included in the standards as a list.

Quality Management (Control) in CPA Firms

LO 2-7

Describe the quality management (control) standards and regulation of accounting firms.

Both the AICPA and the PCAOB have developed CPA firm standards that require a firm to implement a **system of quality management (system of quality control per PCAOB)**¹⁰ for the firm's accounting and auditing practice. These standards require CPA firms to design, implement, and operate a system that provides reasonable assurance that

¹⁰ The AICPA's standards are titled *Statements on Quality Management Standards (SQMs)* and the PCAOB's standards are *Quality Control Standards (QCS)*. Since the two organizations use differing terminology, when speaking about the standards in general terms we will use the term "quality standards" or "quality management (control) standards."

the firm follows professional standards and legal requirements on engagements and issues appropriate reports. In this chapter, we discuss the profession's (1) quality standards and (2) the related engagement reviews and inspections. These reviews and inspections are a significant part of assuring compliance with a firm's quality standards and identifying needed improvements in quality standards.

The Quality Standards

The AICPA's overall approach to developing quality standards involves establishing quality objectives and responding to quality risks. **Quality risks** are risks with a reasonable possibility of occurring and adversely affecting the achievement of one or more quality objectives. Accordingly, the risk-based assessment process involves the following three steps:

- Establish quality objectives;
- Identify and assess quality risks to the achievement of the quality objectives; and
- Design and implement **quality responses** to address the risks.

The AICPA structures its guidance around the eight integrated components of quality management (control) presented in Figure 2.8.¹¹ The figure also includes basic quality objectives to be achieved for each component and provides example policies and procedures that a CPA firm might implement to achieve that objective.

FIGURE 2.8 Components of Quality Management*

Component of Quality Management	Quality Objectives	Example policies and procedures
1. The Firm's Risk Assessment Process	Design and implement a risk assessment process to • Establish quality objectives, • Identify and assess quality risks, and • Design and implement responses to address quality risks.	The firm establishes policies or procedures for consultation on risk-related matters, which include with whom and the specific matters for which consultation is required. The firm appoints suitably qualified and experienced individuals to provide the consultations.
2. Governance and Leadership	Meet governance and leadership quality objectives that indicate: • A culture with a commitment to quality is established. • Leadership is responsible and accountable for quality. • Leadership demonstrates a commitment to quality through its actions and behaviors. • Appropriate organizational roles, responsibilities, and authority are established. • Appropriate resources are provided.	Leadership establishes the tone at the top through its actions and behaviors, communications at all levels within the firm that collectively contribute to the firm's culture and demonstrates a commitment to quality.
3. Relevant Ethical Requirements	Establish the ethical quality objectives that address compliance with ethical requirements, including those related to independence of • The firm and its personnel. • Others (e.g., network firms and service providers).	• The firm prohibits the acceptance of gifts and other forms of hospitality from a client, even if the value is trivial and inconsequential. • The firm sets rotation periods for all engagement partners, including those performing attestation, review, and compilation engagements.

(Continues)

¹¹ CPA firms are in the process of revising their systems to this eight-component approach. For engagements covering financial statements for the period starting before December 15, 2025, they may use the prior AICPA quality standards, which are similar to the PCAOB requirements discussed below.

FIGURE 2.8 Components of Quality Management* (Continued)

Component of Quality Management	Quality Objectives	Example policies and procedures
4. Acceptance and Continuance of Client Relationships and Specific Engagements	Establish client quality objectives that address client relationships that include: • Whether to accept or continue a client or specific engagement. • Determining that financial and operational priorities do not lead to inappropriate decisions.	For a potential new client, the firm obtains information about integrity and ethical values, including the business reputation of the client's principal owners, key management, and those charged with its governance.
5. Engagement Performance	Establish engagement performance quality objectives that address: • Engagement teams' understanding of responsibilities. • Appropriate supervision, professional judgment, and consultation policies. • Differences of opinion, ensuring that they are brought to the attention of the firm and resolved. • Proper engagement documentation.	Direction and supervision of the engagement team includes: • Tracking progress of the engagement. • Determining that staff understand their instructions. • Determining that engagement is being carried out as planned.
6. Resources	Establish quality objectives for obtaining, developing, using, maintaining, allocating, and assigning resources in a timely manner to enable the design, implementation, and operation of the system of quality management in the following areas: • Human resources. • Technological resources. • Intellectual resources. • Service providers.	In recruiting, effective procedures are developed to help the firm select individuals with integrity and the needed academic preparation to develop the necessary competence and capabilities.
7. Information and Communication	Establish information and communication quality objectives that enable the design, implementation, and operation to ensure: • Information system supports the system of quality management. • Information exchange in the firm and with one another is encouraged by culture of firm. • Information is exchanged throughout firm. • Information is communicated to external parties as appropriate.	The firm communicates: • Changes to the system of quality management to personnel and engagement teams to the extent that the changes are relevant to their responsibilities. • Relevant information obtained during the firm's acceptance and continuance process is communicated to engagement teams in planning and performing engagements.
8. The Monitoring and Remediation Process	Monitor the entire quality management system and remediate deficiencies, including those related to: • In-process engagements. • Completed engagements and engagement partners.	The firm inspects a completed engagement for each engagement partner performing audits of financial statements once every three years, and for all other engagement partners, once every five years.

*Adapted from AICPA QM 10, *A Firm's System of Quality Management*.

The eight components are based on those of the International Auditing and Assurance Standards Board. They differ from the international standards, when considered necessary, to adapt them to the U.S. environment and terminology.

The PCAOB's quality control policies and procedures are composed of five elements:

- Personnel Management;
- Independence, Integrity, and Objectivity;
- Acceptance and Continuance of Clients and Engagements;
- Engagement Performance; and
- Monitoring.

The five elements are similar to five of the eight AICPA components (i.e., numbers 2, 3, 4, 5, and 7) in Figure 2-8. The PCAOB standards do not explicitly include Risk Assessment, Information and Communication, and Monitoring (numbers 1, 6, and 8). Currently, the PCAOB is considering modifying its standards to adopt the eight-component approach.

The specific quality policies and procedures adopted by CPA firms differ due to factors such as the size of the firm, the number of offices, and the nature of the firm's practice. Thus, those adopted by a 200-office international firm will differ considerably from those of a single-office firm that audits only small businesses. Technically, the public and nonpublic company quality standards apply only to auditing, other attestation, and accounting services for which professional standards have been established. As a practical matter, every CPA firm should establish quality policies and procedures applicable to all aspects of its practice. In a broad sense, the concept of "quality management (control)" means that CPA firms should establish controls to provide assurance that they meet their responsibilities to their clients and to the public.

Quality Management (Control): Engagement Reviews and Inspections

As shown in Figure 2.8, monitoring of specific engagements represents a required component of the AICPA quality management standards. PCAOB standards also include requirements for reviews and inspections. It is particularly important to assure quality by having various quality reviews and inspections of audits and other attestation engagements. In the following sections, we consider three categories of engagement reviews and inspections, including

- Engagement quality reviews,
- Completed engagement inspections, and
- Peer reviews and PCAOB inspections.

The first two categories of reviews and inspections are ordinarily performed by members of the firm itself (or non-firm personnel hired by the CPA firm), while the third is performed by either other CPA firms ("peers") or the PCAOB.

Engagement Quality Reviews

An **engagement quality review** is performed prior to issuance of the engagement report by a quality reviewer who is otherwise independent of the engagement. These reviews focus on significant judgments and conclusions made by the audit team on the engagement, as contrasted to a complete review of the engagement. The quality reviewer is ordinarily a partner or high-level employee of the CPA firm who is independent of the audit and has the needed expertise. Alternatively, firms may engage non-firm personnel to perform engagement quality reviews. As an example, a small CPA firm may engage a partner from another CPA firm when its audit team represents the only personnel with the needed expertise to perform a review. It is essential that the personnel performing the review be independent from the engagement itself.

AICPA *Statement on Quality Management No. 2 Engagement Quality Reviews* and PCAOB AS 1220 *Engagement Quality Review* address the performance and documentation of engagement quality reviews, including the appointment of reviewers. The AICPA only requires nonpublic company engagement quality reviews when (1) it is required by law or (2) the firm determines that such a review is an appropriate response to address one or more *quality risks*. The PCAOB requires engagement quality reviews as a part of

all public company audits and reviews. Also, under PCAOB requirements, when a change in engagement partner occurs, that person may not serve as the **engagement quality reviewer** for two periods subsequent to the period they served as the engagement partner. However, this “cooling off” period is not required for certain very small CPA firms.

An engagement quality review is completed prior to issuance of the audit report, with any quality review concerns over significant judgments and conclusions having been resolved. If such concerns are not resolved to the quality reviewer’s satisfaction, the quality reviewer should notify appropriate individuals in the firm that the engagement quality review cannot be completed. Such unresolved concerns may require further consultation within or outside the firm (e.g., with a professional regulatory body).

Completed Engagements Inspections

The quality standards of both the AICPA and the PCAOB require the performance of inspections of a sample of completed engagements. CPA firms inspect a sample of engagements to evaluate the adequacy of the firm’s quality policies and procedures, its personnel’s understanding of those policies and procedures, and the extent of the firm’s compliance with its quality policies. One overall requirement is that at least one completed engagement for each engagement partner be inspected on a cyclical basis determined by the firm (e.g., once every three years). Additionally, CPA firms may choose to inspect engagements that are in process.

The scope of completed engagement inspections (engagement reviews) varies based on details of the CPA firm’s system of quality management (control). Such inspections *ordinarily* involve a review of working papers, reports, and client financial statements by an individual not directly associated with the engagement being inspected. While neither the AICPA nor the PCAOB standards preclude particular individuals (e.g., the previous engagement partner who rotated off the engagement) from performing monitoring activities, including inspections, additional safeguards should be implemented to assure objectivity in such situations. The most frequent situation resulting in such self-inspection is where a small firm lacks other competent individuals to perform the function for a particular client. To resolve this situation, the CPA firm may decide to engage non-firm personnel to perform these inspections.

Peer Reviews and PCAOB Inspections

Members of the AICPA who are in public practice with a firm that performs accounting services that are in the scope of the AICPA’s practice-monitoring standards (i.e., most accounting and attestation services) must practice with a firm that is enrolled in the AICPA Peer Review Program. Enrollment in this program requires the firm to undergo a **peer review** every three years performed by another CPA, a CPA firm, or a team of CPAs. In practice, there are two types of peer reviews: *system reviews* and *engagement reviews*.

A *system review* involves the peer reviewers’ study and appraisal of a CPA firm’s system of quality management (control) related to accounting and auditing engagements. The approach to these peer reviews includes obtaining an understanding of the CPA firm’s accounting and auditing practice and the design of the firm’s system through inquiry of CPA firm personnel and review of documentation about the system. The peer reviewers also select a sample of the CPA firm’s engagements (emphasizing the higher risk ones) and examine related working paper files and reports, interview selected CPA firm personnel, and examine various administrative and personnel files. The peer review report issued includes a rating of pass, pass with deficiencies, or fail. A pass rating provides reasonable assurance in that it includes the peer reviewers’ opinion that the system is appropriately designed and is being complied with by the CPA firm in all material respects. A pass with deficiencies rating indicates that in certain situations (outlined in the report) the system is not appropriately designed or complied with. Finally, a fail rating indicates that the peer reviewer believes that the CPA firm’s system is not suitably designed or there is inadequate compliance with the policies and procedures.

An *engagement review*, the second type of peer review, is one in which the peer reviewers select a sample of a CPA firm's actual accounting and review work, including reports issued and the CPA firm's documentation, to evaluate whether the work and reports are appropriate. This type of peer review is of lesser scope because it does not focus on the overall system of quality management. An engagement review is only available for CPA firms that do not perform audits but do perform reviews and/or compilations. The report issued expresses a rating of pass, pass with deficiencies, or fail, as is the case with a system review. However, the restricted nature of an engagement review results in pass and pass with deficiencies reports that provide only limited assurance. As an example, the wording of a pass report indicates that nothing came to the peer reviewers' attention indicating a material departure from professional standards.

In addition to peer reviews, CPA firms with SEC registrants as clients are required to have **external inspections** performed by the PCAOB staff. As indicated earlier, inspections are performed annually for CPA firms with numerous public clients and less frequently for those with fewer public clients. The Sarbanes–Oxley Act provides that an **inspection** shall include at least the following three general components:

1. An inspection and review of selected audit and review engagements;
2. An evaluation of the sufficiency of the quality control system of the firm and the manner of documentation and communication of the system; and
3. Tests of the audit, supervisory, and quality control procedures.

Inspections by the PCAOB staff differ from peer reviews conducted by CPA firms. Generally, the PCAOB staff focuses on selected quality control issues only and also may consider other aspects of practice management, such as the determinants of partner compensation. In addition, while peer reviews focus on evaluating and testing compliance with the firm's quality management system, a PCAOB inspection focuses primarily on evaluating the performance of a sample of individual audit and review engagements. In selecting the engagements for inspection, the PCAOB staff emphasizes a risk assessment approach to identify engagements that have a higher risk of lack of compliance with professional standards, although a number of audits are selected randomly. As an example, an engagement may be considered risky because it involves the audit of an undercapitalized technology company. Once an audit is selected, the inspection focuses on the high-risk aspects of that engagement, such as the audit work on revenue recognition and accounting estimates. When a lack of compliance with professional standards is found, the PCAOB staff attempts to determine the cause of the lack of compliance, which may lead to the identification of a defect in the firm's system of quality control. In 2019, the PCAOB established a "target team" to perform inspection procedures across engagements of a number of inspected firms relating to current audit risks and emerging topics (e.g., audits in which more than one CPA firm is involved, or financial statement areas with increased risks due to the COVID pandemic).

Each inspection results in a written report transmitted to the SEC and appropriate regulatory authorities. Also included is a letter of comments by the PCAOB inspectors and any responses by the CPA firm. While the content of most portions of the reports is made available to the public, discussions of potential defects in a firm's system of quality control are not made public unless the firm does not address the issues within 12 months.

Various external oversight authorities require the performance of inspections in particular circumstances. In addition to the PCAOB, examples include the U.S. Department of Labor, the U.S. Department of Housing and Urban Development, and the Government Accountability Office.

Recap of Review and Inspection Engagements

Engagement reviews and inspections are an important part of assessing a firm's compliance with its quality standards, particularly monitoring. In addition to ordinary review of the work performed within an audit performed by audit team members (e.g., an in-charge



Illustrative Case

Inspections of Registered Audit Firms Located Outside the United States

A significant challenge related to the PCAOB inspection program relates to registered audit firms that are domiciled outside of the United States. Under the Sarbanes–Oxley Act, the PCAOB is charged with inspecting all registered firms regardless of where they are located. However, the PCAOB historically has been denied the ability to conduct inspections of audits of Chinese-based companies by the People's Republic of China and Hong Kong. If the PCAOB cannot inspect an audit firm, the SEC could decide to force delisting a company audited by the firm. However, the SEC has decided that the economic and political repercussions of such action would be too great. Instead, the PCAOB and the SEC have taken the approach

of notifying the securities markets by releasing the names of issuers registered with the SEC whose auditors are located in a country that does not allow the PCAOB to conduct inspections.

To respond to this issue, Congress passed the Holding Foreign Companies Accountable Act in 2020, which requires these firms to prove they are not owned or controlled by a foreign government, such as China. In addition, if the companies cannot be reviewed for three years in a row, they will be banned from trading on U.S. exchanges. The SEC and the PCAOB have continued to work with the Chinese government to resolve the situation and in 2022 the PCAOB announced that it was able to secure complete access to inspect and investigate audit firms in mainland China and Hong Kong.

accountant's review of a subordinate's work and, ultimately, the engagement partner's review of all of the work), an engagement also may include:

1. An *engagement quality review* that addresses the engagement's significant judgments and conclusions reached. Engagement quality reviews, required by the PCAOB, are completed prior to issuance of the engagement report, and ordinarily performed by firm personnel who are otherwise independent of the audit and the client.
2. A *completed engagement inspection* includes review of engagement documentation, reports issued, and the client's financial statements to provide support that the firm's engagements are meeting quality requirements. While these inspections are ordinarily performed subsequent to completion of the audit, in certain situations it may be performed while the engagement is in process. It is ordinarily performed by firm personnel otherwise independent of the audit and the client to assure objectivity.
3. *Peer reviews and PCAOB inspections* (or inspections required by another regulatory agency) ordinarily consider the firm's quality management (control) system and engagement performance. Most frequently these engagements are performed subsequent to conclusion of the audit by another CPA firm or a regulatory agency.

International Accounting and Auditing Standards

LO 2-8

Explain the status of international accounting and auditing standards and the content of the international audit report.

International Financial Reporting Standards (IFRS) are developed by the **International Accounting Standards Board (IASB)**, which has the objective of developing, in the public interest, a single set of high-quality understandable and enforceable global accounting standards. Historically, the SEC has required foreign companies that issue their securities in U.S. markets to present their financial statements in accordance with U.S. generally accepted accounting principles (GAAP) or reconcile their financial statements to U.S. GAAP. In 2008, the SEC eliminated the requirement when the financial statements have been prepared using IFRS.

Acceptance of IFRS by the SEC does not alter the requirements for audits of the financial statements by a registered CPA firm under the auditing standards established by the PCAOB. However, it does have some impact on the audit process because of the differences between IFRS and U.S. GAAP. Apart from some specific differences in rules, IFRS are considered to be more principles-based than U.S. GAAP, which are considered more rules-based. Therefore, IFRS generally require the application of more judgment. Many professionals believe that the judgment involved in the application of IFRS makes audits of financial statements prepared in accordance with IFRS somewhat more challenging than audits of financial statements prepared in accordance with U.S. GAAP.

The International Audit Report

The international auditing standards are developed by the **International Federation of Accountants (IFAC)**'s International Auditing and Assurance Standards Board (IAASB) for both public and nonpublic companies. Following is its unmodified audit report.

Independent Auditor's Report

To the Shareholders of ABC Company:

Report on the Audit of the Financial Statements

Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as of December 31, 20X1, and the statement of comprehensive income, statement of changes in equity, and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting standards.

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the International Ethics Standards Board of Accountants' *Code of Ethics for Professional Accountants (IESBA Code)* together with the ethical requirements that are relevant to our audit of the financial statements in the United States, and we have fulfilled our other ethical responsibilities in accordance with these standards and the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with IFRSs, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the audit.* We also

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error; design and perform audit procedures responsive to those risks; and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

*The ISA allows the information in this and the next three paragraphs to be included in the body of the audit report (as here), in an appendix to the audit report, or in an appropriate website that presents the information.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purposes of expressing an opinion on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and, where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

The engagement partner on the audit resulting in this independent auditor's report is Robert Blue.

February 17, 20X2
Los Angeles, California, USA

Robert Blue
Blue, Gray & Company

Most public company international audit reports also include a section on **key audit matters (KAMs)**, while inclusion for a nonpublic company is dependent upon terms of the engagement.

Notice that the international report is similar to the Auditing Standards Board non-public company audit report. One difference is that the international report description of auditor responsibilities is more detailed; also that description may be moved to an appendix to the audit report or to an appropriate website—these options are not allowed for ASB reports. The report also includes necessary changes in terminology to refer to international accounting, auditing, and ethics standards.

The international reporting model also allows the auditors certain other reporting options. As an example, instead of indicating that the financial statements “present fairly, in all material respects,” the auditors may substitute the phrase “give a true and fair view,” as required of auditors in the United Kingdom. Also, the report may indicate that the financial statements comply with the provisions of the country's relevant statutes or laws. The report may be signed using the personal name of the auditor, the firm, or both—as is done in the preceding illustration. Inclusion of the city of the CPA firm office that performed the audit is a required part of the international report.

In some countries, auditors have other reporting responsibilities, such as a responsibility to report certain matters that come to the auditors' attention. If those matters are presented in the international audit report on the financial statements, they should be included in a separate section of the report after the opinion paragraph.

Government, Single, and ERISA Audits

LO 2-9

Describe the nature of audits performed in accordance with *Generally Accepted Government Auditing Standards* and the Single Audit Act, and of audits of employee benefit plans subject to the Employee Retirement Income Security Act of 1974.

Audits in Accordance with Government Auditing Standards and the Single Audit Act

There are several types of entities that are regulated by a state or federal government organization that prescribes standards and other requirements for audits of the entities. Prominent among these regulators are the Government Accountability Office and the Department of Labor.

The Government Accountability Office issues **Generally Accepted Government Auditing Standards** (GAGAS) for federal entities and organizations that receive federal financial assistance. The standards apply to state and local government entities and not-for-profit organizations when the audits are required by law, regulation, or an agreement. It is important for auditors to be familiar with these standards because they impose additional requirements related to (1) ethics, independence, and professional judgment; (2) competence and continuing education; (3) quality management (control) and peer review; (4) audit communication; (5) considering the results of previous audits; (6) noncompliance with provisions of contracts and grant agreements; (7) findings; (8) audit documentation; and (9) reporting. Audits in accordance with GAGAS are covered in detail in Chapter 21. Here we provide a summary of the major GAGAS performance requirements for CPA firms and auditors. The auditors should:

1. Assure that auditors who are assigned to the engagements have completed at least 80 hours of continuing professional education in every two-year period, with at least 24 hours on government entities or government auditing.
2. Obtain external peer reviews that are sufficient in scope to provide a reasonable basis for determining whether (1) the reviewed audit organization's system of quality management (control) was suitably designed and (2) the organization is complying with its system.
3. Communicate information about the nature of the audit and the level of assurance provided to appropriate oversight bodies requiring the audits, and to those legislative committees, if any, that have ongoing oversight responsibilities for the audited entity.
4. Consider the results of previous audits and follow up on known significant findings and recommendations in prior-year audit reports.
5. Plan and perform procedures to develop the criteria, condition, cause, and effect of identified findings.
6. Document evidence of supervisory review of the work performed, and any departures from GAGAS and the impact on the audit or the auditors' conclusions.
7. Report on compliance with laws and regulations and on internal control.

The **Single Audit Act** requires state and local governments, and nonprofit organizations that expend federal financial assistance of \$750,000 or more within a fiscal year to have a single audit. The requirements of a single audit include determining and reporting on whether (1) the financial statements are presented fairly in all material respects in accordance with generally accepted accounting principles; (2) the accompanying schedule of expenditures of federal awards is fairly presented in all material respects in relation to the financial statements taken as a whole; and (3) the entity complied with the provisions of laws, regulations, and contracts or grants that may have a direct and material effect on each major federal financial assistance program. The requirements also include obtaining an understanding of internal control pertaining to compliance with the provisions of laws, regulations, contracts, or grants that may have a material effect on each major federal financial assistance program; assessing control risk; and performing tests of controls. The Single Audit Act is discussed in more detail in Chapter 21.

Audits of Employee Benefits Plan Financial Statements

Under the **Employee Retirement Income Security Act of 1974 (ERISA)**, the Department of Labor (DOL) sets standards for most voluntarily established retirement and health plans in private industry with a goal of providing protection for individual members of

the plans. These plans must provide annual financial statements and supplemental schedules (e.g., a detailed schedule of assets held and their values as of year-end) to their members. Section 103 of ERISA requires these plans to engage auditors to audit their financial statements in accordance with generally accepted auditing standards and provide an opinion on whether the plan's financial statements are prepared following generally accepted accounting principles.

The DOL and AICPA (AU-C 703) have issued specialized standards for the audits of the financial statements of employee benefit plans. While these audits are conducted following generally accepted auditing standards, much of the focus is on (1) employee and employer contributions, (2) loans and distributions, and (3) controls relating to a plan. Specifically, the auditors should:

1. Read the plan instrument and effective amendments for provisions that affect the risks of material misstatement and consider whether management has conducted the compliance tests required by the Internal Revenue Code.
2. Obtain representations of management indicating that management is responsible for maintaining and administering the plan instrument.
3. Evaluate whether all prohibited transactions have been reported on the ERISA required supplementary schedule.
4. Follow the DOL requirements for independence.

Employee benefit plans ordinarily have a large amount of investments in contemplation of payments for employee retirement and other benefits. These investments are typically held by a **qualified institution** that serves as a trustee or custodian of plan investments.

Reporting on Employee Benefit Plans

Depending upon the circumstances, auditors may be engaged to perform either of two types of audits. In the first type of audit, the scope of the audit includes the entire financial statements of the plan (previously, this was referred to as a *full scope audit*). Assurance provided in the audit report issued for this type of engagement may be viewed as including two parts:

1. An overall audit opinion on whether the financial statements are presented fairly in accordance with GAAP.
2. An opinion on whether the supplemental schedule(s) is fairly stated in relation to the financial statements as a whole following DOL requirements, included as a separate section of the audit report.

The second type of audit is referred to as an ERISA section 103(a)(3)(C) audit (previously referred to as a *limited scope audit*). In performing this type of audit, the auditors audit the overall financial statements but rely upon the qualified institution's certification of the plan's investment assets. Since the auditors do not perform procedures to audit the investments held by the qualified financial institution, their opinion indicates that investments agree to or are derived from the certified investment information provided by the qualified institution. Audits of employee benefit plans are discussed in greater detail in Chapter 19.

Chapter Summary

This chapter described the nature of generally accepted auditing standards, attestation standards, and quality standards. To summarize:

1. The passage of the Sarbanes–Oxley Act of 2002 significantly altered the regulatory environment of auditors and audit firms. Previously, the AICPA played a primary role in the development of auditing, attestation, and quality standards and in the self-regulation of individual auditors and CPA firms. Now, the AICPA issues those standards that are only applicable to nonpublic engagements. The PCAOB issues

standards for public company audits and regulates the public company practices of auditors and registered audit firms.

2. The AICPA issues *Statements on Auditing Standards*, which represent generally accepted auditing standards relevant to the audits of nonpublic (nonissuer) companies. The PCAOB adopted AICPA standards in existence at April 16, 2003, and began issuing its own standards. Subsequently, it recodified all the standards into a single framework referred to as Auditing Standards.
3. An audit obtains reasonable assurance of detecting material misstatements of the financial statements (both errors and fraud) and noncompliance with laws that have a direct and material effect on the determination of financial statement amounts. Although an audit does not obtain reasonable assurance of detecting noncompliance with laws that have only an indirect effect on the financial statements, the auditors remain alert for such acts. If instances of possible illegal acts are discovered, regardless of type, the auditors should carefully evaluate their possible effects on the financial statements.
4. The auditors' report with an unqualified opinion on the financial statements of a public (issuer) company begins with an Opinion section, followed by a Basis for Opinion section and a Critical Audit Matters section. When internal control has been audited, the report also contains a paragraph referring to the auditors' report on internal control (or combines the two reports into a single report with opinions on both the financial statements and internal control). Public company reports indicate that the audit was performed in accordance with "standards of the PCAOB."
5. The auditors' report with an unmodified opinion for a nonpublic (nonissuer) company consists of sections on (1) the opinion, (2) the basis for its opinion, (3) management's responsibility, and (4) the auditors' responsibility. It may also include sections on key audit matters when included in the terms of the engagement and on other information when the financial statements are included in an annual report. Nonpublic company reports indicate that the audit was performed in accordance with "auditing standards generally accepted in the United States of America."
6. Alternatives to unmodified opinions (unqualified opinion per PCAOB standards) are qualified opinions, adverse opinions, and disclaimers of opinion. Qualified opinions are issued when there is a limitation on the scope of an audit or when financial statements are not presented in accordance with generally accepted accounting principles. Adverse opinions are issued when financial statements are pervasively misstated and thus not fairly presented on an overall basis. Disclaimers of opinion are issued when the auditors are unable to conclude on the overall fairness of the financial statements.
7. The AICPA's attestation standards were adopted to provide a general framework for the attest function and to set boundaries for these types of engagements other than audits of financial statements and integrated audits of financial statements and internal control. The types of engagements established under *Statements on Standards for Attestation Services* are agreed-upon procedures, reviews, and examinations.
8. CPA firms establish quality management (control) systems to ensure that professional engagements are performed in accordance with applicable professional standards. The profession's quality standards provide guidance in developing these systems. CPA firms undergo a variety of reviews and inspections. Engagement quality reviews ordinarily occur prior to issuance of an engagement report and address significant judgments and conclusions reached by the engagement team. Completed engagement inspections include review of engagement documentation, reports issued, and the financial statements to provide support that quality management (control) standards are being met. Peer reviews and PCAOB inspections are performed by individuals external to the CPA firm and also address quality management (control) and engagement performance.

9. International financial markets would be facilitated if auditing and accounting standards were more uniform. Currently, the International Auditing and Assurance Standards Board issues pronouncements designed to foster the development of consistent worldwide auditing standards.
10. A variety of audit requirements exist relating to government regulated organizations. The Government Accountability Office issues *Generally Accepted Government Auditing Standards* (GAGAS) for use in auditing federal entities and organizations that receive federal financial assistance. Also, organizations receiving \$750,000 or more in federal assistance are subject to the Single Audit Act, which requires a more extensive audit. Organizations with employee benefit plans subject to the Employee Retirement Income Security Act of 1974 (ERISA) file a Form 5500 with the Department of Labor that includes audited financial statements. The Department of Labor has established additional requirements for the audits of the financial statements of these plans.

Key Terms Introduced or Emphasized in Chapter 2

Adequate disclosure (53) All essential information as required by generally accepted accounting principles (or some other appropriate basis of accounting) is included in the financial statements.

Adverse opinion (54) An opinion issued by the auditors that the financial statements they have audited *do not present fairly* the financial position, results of operation, or cash flows in conformity with accounting principles generally accepted in the United States of America.

Applicable financial reporting framework (41) The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation of the financial statements that are acceptable in view of the nature of the entity and the objectives of the financial statements, or that is required by law or regulation.

Audit risk (45) The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.

Auditors' report (39) A very precise document designed to communicate exactly the character and limitations of the responsibility being assumed by the auditors.

Consistency (52) The concept of using the same accounting principles from year to year so that successive financial statements issued by a business entity will be comparable.

Critical audit matters (50) Matters that were communicated or required to be communicated to the audit committee and that (1) relate to accounts or disclosures that are material to the financial statements, and (2) involved especially challenging, subjective, or complex auditor judgment. Critical audit matters are communicated for the audits of public companies.

Disclaimer of opinion (54) A form of report in which the auditors state that they do not express an opinion on the financial statements; it should include a separate paragraph stating the auditors' reasons for disclaiming an opinion and also disclosing any reservations they may have concerning the financial statements.

Employee Retirement Income Security Act of 1974 (ERISA) (64) A federal law that sets minimum standards for most voluntarily established retirement and health plans in private industry designed to provide protection for individuals in these plans.

Engagement quality reviewer (59) A partner, other individual in the firm, or an external individual appointed by the firm to perform the engagement quality review. The engagement quality reviewer should not be a member of the engagement team.

Engagement quality review (58) An objective evaluation of the significant judgments made by the engagement team and the conclusions reached thereon performed by the engagement quality reviewer and completed before the engagement report is released.

Error (45) An unintentional misstatement of financial statements or omission of an amount or a disclosure.

External inspection (60) An inspection undertaken by an external oversight authority related to the firm's system of quality management or engagements performed by the firm. Examples of external oversight authorities include the PCAOB, the U.S. Department of Labor, the U.S. Department of Housing and Urban Development, and the Government Accountability Office.

Financial reporting framework (41) A set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements; for example, accounting principles generally accepted in the United States of America, or *International Financial Reporting Standards (IFRS)* issued by the International Accounting Standards Board (IASB).

Fraud (45) For financial statement audits, “fraud” includes two types of intentional misstatements of financial statements: misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets. Legally, fraud is the misrepresentation by a person of a material fact, known by that person to be untrue or made with reckless indifference as to whether the fact is true, with intent to deceive and with the result that another party is injured.

General-purpose financial reporting framework (52) A financial reporting framework designed to meet the common financial information needs of a wide range of users.

Generally accepted auditing standards (GAAS) (39) Auditing standards issued by the AICPA’s Auditing Standards Board (ASB). GAAS are the standards for the auditors’ work in fulfilling the overall objectives of a financial statement audit. GAAS address the general responsibilities of the auditors as well as the auditors’ further considerations relevant to the application of those responsibilities.

Generally Accepted Government Auditing Standards (64) Auditing standards for federal entities and organizations that receive federal financial assistance. The standards apply to state and local government entities and not-for-profit organizations when the audits are required by law, regulation, or an agreement. Also referred to as Government Auditing Standards.

Independence (43) A most important auditing standard, which prohibits CPAs from expressing an opinion on financial statements of an enterprise unless they are independent with respect to such enterprise; independence is impaired by a direct financial interest, service as an officer or trustee, certain loans to or from the enterprise, and various other relationships.

Inspection (60) An evaluation of the adequacy of aspects of the firm’s quality management policies and procedures, its personnel’s understanding of those policies and procedures, and the extent of the firm’s compliance with them. An external inspection performed by the PCAOB leads to an assessment of the degree of compliance of each registered public accounting firm and associated persons of that firm with the Sarbanes–Oxley Act of 2002 and the board’s requirements in connection with its performance of audits, issuance of audit reports, and related matters.

Integrated audit (under PCAOB AS 2021 (39)) An audit in which auditors, in addition to an opinion on the financial statements, express an opinion on the effectiveness of a company’s internal control over financial reporting, in accordance with PCAOB AS 2201. Public companies with a market capitalization of \$75,000,000 or more are required to undergo integrated audits.

Internal control (42) A process, effected by the entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the categories of (1) operations, (2) reporting, and (3) compliance.

International Accounting Standards Board (IASB) (61) An independent, privately funded accounting standard setter that is committed to developing a single set of high-quality, understandable, and enforceable global accounting standards.

International Auditing and Assurance Standards Board (IAASB) (39) A committee of the International Federation of Accountants, established to issue standards on auditing and reporting practices to improve the degree of uniformity of auditing practices and related services throughout the world.

International Federation of Accountants (IFAC) (62) A worldwide organization of national accounting bodies established to help foster a coordinated worldwide accounting profession with harmonized standards.

Key audit matters (KAMs) (51, 63) As included in the AICPA and international auditing standards, matters that, in the auditor’s professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated to those charged with governance.

Other information (51) Financial and nonfinancial information (other than the financial statements and the auditors’ report thereon) included in an entity’s annual report.

Peer review (59) A study and appraisal by an independent evaluator (“peer reviewer”) of a CPA firm’s work. In a *system review*, the evaluator considers the CPA firm’s system of quality control to perform accounting and auditing work. In an *engagement review*, the evaluator studies and evaluates a sample of a CPA firm’s actual accounting work, including accounting reports issued and documentation prepared by the CPA firm as well as other procedures that the firm performed. Engagement reviews are only available for CPA firms that do not perform audits or other similar engagements.

Professional skepticism (41) An attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatements due to fraud or error, and a critical assessment of audit evidence.

Public Company Accounting Oversight Board (PCAOB) (39) A board established by the Sarbanes–Oxley Act of 2002 to provide oversight of accounting firms that audit public companies by (1) establishing or adopting professional and ethical standards, (2) conducting inspections of CPA firms, and (3) enforcing compliance with professional and ethical standards. The board is composed of five individuals appointed by the SEC.

Qualified institution (65) Under Department of Labor (DOL) regulations, a qualified institution is one that is regulated and subject to periodic examination by a state or federal agency such as a bank, trust company, or similar institution including an insurance company.

Qualified opinion (54) The appropriate form of audit report when there is a limitation in the scope of the audit or when the financial statements depart from GAAP significantly enough to require mention in the auditors' report, but not so significantly as to necessitate disclaiming an opinion or expressing an adverse opinion.

Quality responses (56) Policies and procedures designed to address quality risks, i.e., risks to achieving quality objectives.

Quality risks (56) Risks that have a reasonable possibility of (1) occurring and (2) individually, or in combination with other risks, adversely affecting the achievement of one or more quality objectives.

Quality standards (39) Standards for establishing quality control policies and procedures that provide reasonable assurance that all of a CPA firm's engagements are conducted in accordance with applicable professional standards.

Reasonable assurance (42) In the context of an audit of financial statements, a high, but not absolute, level of assurance that the financial statements do not contain material misstatements due to errors or fraud. A level of reasonable assurance implies a low level of audit risk, the risk that the auditors express an inappropriate audit opinion when the financial statements are materially misstated.

Single Audit Act (64) Legislation passed by the U.S. Congress that establishes uniform requirements for audits of federal financial assistance provided to state and local governments. The act was significantly amended in 1996.

Standard report (47) An audit report with (1) an unmodified (unqualified) opinion and (2) no additional matters emphasized (e.g., a change in accounting principles) beyond the information required in audit reports. Note that while this term is frequently used in practice, neither the AICPA nor the PCAOB currently uses it in its standards.

System of quality control (55) A process to provide the firm with reasonable assurance that its personnel comply with applicable professional standards and the firm's standards of quality (per PCAOB).

System of quality management (55) A system designed, implemented, and operated by a firm to provide the firm with reasonable assurance that (1) the firm and its personnel fulfill their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and it conducts engagements in accordance with such standards and requirements, and (2) engagement reports issued by the firm are appropriate in the circumstances (per AICPA).

Review Questions

- 2–1. Contrast the roles of the AICPA and the PCAOB in the development of auditing standards.
- 2–2. What is the difference between generally accepted accounting principles (GAAP) and AICPA generally accepted auditing standards (GAAS)?
- 2–3. What is a financial reporting framework? Why is a financial reporting framework important to a financial statement audit?
- 2–4. What relationship exists between AICPA generally accepted auditing standards (GAAS) and the *Statements on Auditing Standards (SASs)*?
- 2–5. In the context of an audit of financial statements, explain what is meant by professional skepticism.
- 2–6. Explain briefly the auditors' responsibility for detecting noncompliance with laws by clients.

- 2-7. Evaluate the following quotation: “If a CPA firm completes a nonpublic company audit of Adam Company’s financial statements following AICPA generally accepted auditing standards and is satisfied with the results of the audit, an unmodified audit report may be issued. On the other hand, if no audit is performed of the current year’s financial statements, but the CPA firm has performed satisfactory audits in prior years, has confidence in the management of the company, and makes a quick review of the current year’s financial statements, a qualified report may be issued.” Do you agree? Give reasons to support your answer.
- 2-8. Pike Company has had an annual audit performed by the same firm of certified public accountants for many years. The financial statements and copies of the audit report are distributed to stockholders each year shortly after completion of the audit. Who is primarily responsible for the fairness of these financial statements? Explain.
- 2-9. What are the titles of the sections of the public and nonpublic company audit reports presented in the chapter?
- 2-10. Davis & Co., Certified Public Accountants, after completing an audit of Samson Company, decided that it would be unable to issue an unmodified opinion. What circumstances might explain this decision?
- 2-11. State the principal assertions made by the auditors in the “Opinion on the Financial Statements” section of the PCAOB auditors’ report with an unqualified opinion. Assume that the auditors issued a separate report on internal control.
- 2-12. What does a nonpublic company audit report say concerning the risk of not detecting a material misstatement resulting from fraud versus one resulting from error?
- 2-13. When a CPA firm completes an audit of a nonpublic business and issues a report, does it express an opinion on the client’s accounting records, financial statements, or both? Give reasons.
- 2-14. A CPA firm does not guarantee the financial soundness of a client when it renders an opinion on financial statements, nor does the CPA firm guarantee the absolute accuracy of the statements. Yet the CPA firm’s opinion is respected and accepted. What is expected of the CPA firm in order to merit such confidence?
- 2-15. If a CPA firm has performed a thorough professional audit of a client’s financial statements, should it be able to issue a report dealing with facts rather than the mere expression of an opinion? Explain.
- 2-16. What is a “material” amount from the perspective of auditors? Give an example of how that amount may differ based on the nature of the item.
- 2-17. Explain how the auditors determine whether a client’s accounting is appropriate when the *FASB Codification* includes no specific guidance with respect to accounting for a particular type of transaction.
- 2-18. Do the AICPA attestation standards supersede any of the AICPA generally accepted auditing standards? Explain.
- 2-19. What is the meaning of *quality management (control)* and *peer review* as these terms relate to the operation of a CPA firm? Is peer review mandatory? Explain.
- 2-20. Using the AICPA’s components of quality management, provide the basic quality objectives of establishing quality management procedures in the following areas.
 - a. Engagement performance.
 - b. Resources.
 - c. Information and communication
- 2-21. Do the AICPA’s *Statements on Quality Management Standards* require every CPA firm to implement similar quality management policies and procedures? Explain.
- 2-22. Comment on the following: An engagement quality review is ordinarily performed by a manager on the engagement and reviewed by the engagement partner.
- 2-23. Distinguish between the system review and the engagement review types of peer reviews.
- 2-24. Comment on the following: The SEC’s acceptance of the use of International Financial Reporting Standards in filings replaces use of PCAOB Auditing Standards for audits of international companies.
- 2-25. How does an audit under the generally accepted government auditing standards differ from an audit under generally accepted auditing standards?
- 2-26. What are the two types of audits that may be performed for employee benefit plans under the requirements of ERISA and the Department of Labor? Describe how the audits differ.

Questions Requiring Analysis

LO 2-1

LO 2-1, 3

LO 2-3

LO 2-7

LO 2-9

- 2-27. An attitude of independence is a most essential element of an audit by a firm of certified public accountants. Describe several situations in which the CPA firm might find it somewhat difficult to maintain this independent point of view.
- 2-28. Jane Lee, a director of a nonpublic corporation with a number of stockholders and lines of credit with several banks, suggested that the corporation appoint as controller John Madison, a certified public accountant on the staff of the auditing firm that had made annual audits of the corporation for many years. Lee expressed the opinion that this move would effect a considerable savings in professional fees because annual audits would no longer be needed. She proposed to give the controller, if appointed, an internal auditing staff to carry on such continuing investigations of accounting data as appeared necessary. Evaluate this proposal.
- 2-29. Reed, CPA, accepted an engagement to audit the financial statements of Smith Company. Reed's discussions with Smith's new management and the predecessor auditor indicated the possibility that Smith's financial statements may be misstated due to the possible occurrence of errors, fraud, and illegal acts.
- Identify and describe Reed's responsibilities to detect Smith's errors and fraud. Do *not* identify specific audit procedures.
 - Describe Reed's responsibilities to detect Smith's material noncompliance with laws. Do *not* identify specific audit procedures.
 - Identify and describe Reed's responsibilities to report Smith's noncompliance with laws. (AICPA, adapted)
- 2-30. While the AICPA administers a peer review program for CPA firms, the PCAOB staff performs practice inspections.
- Identify the two basic types of peer review.
 - On what part of a firm's practice does the PCAOB staff focus its inspections?
 - Describe a PCAOB inspection.
 - Describe how the PCAOB staff selects an audit engagement for inspection.
- 2-31. Certain organizations are required to obtain audits that have additional requirements based on laws or regulations.
- Describe the additional requirements of an audit under *Generally Accepted Government Auditing Standards*.
 - Describe the additional requirements of a *Single Audit*.
 - Describe the additional requirements of an audit of an employee benefit plan under ERISA.

Objective Questions

Select questions are available with Connect



LO 2-1

LO 2-2

LO 2-2

- 2-32. **Multiple Choice Questions**
Select the best answer for each of the following items and give reasons for your choice.
- Which of the following organizations can revoke the right of an individual to practice as a CPA?
 - The Public Company Accounting Oversight Board.
 - The American Institute of Certified Public Accountants.
 - The Securities and Exchange Commission.
 - The applicable state board of accountancy.
 - The AICPA over time has played an important role in standards setting. Which of the following standards are currently established by the AICPA?
 - Accounting standards applicable to nonpublic companies.
 - Auditing standards applicable to audits of nonpublic companies.
 - Quality management standards applicable to audits of public companies.
 - Standards for reviews of the interim financial information issued by public companies.
 - Which of the following does the FASB consider a source of nonauthoritative guidance for use when there is no authoritative guidance available?
 - The *FASB Codification*.
 - FASB Concepts Statements*.
 - SEC Rules*.
 - SEC Interpretive Releases*.

LO 2-1

- d. Financial statement audits performed under PCAOB requirements are designed to provide which type(s) of assurance with respect to the detection of material misstatements due to errors or fraud?

	Reasonable	Absolute
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

LO 2-7

- e. A basic objective of a CPA firm is to provide professional services that conform with professional standards. Reasonable assurance of achieving this basic objective is provided through:

- (1) Compliance with generally accepted reporting standards.
- (2) A system of quality management(control).
- (3) A system of peer review.
- (4) Continuing professional education.

LO 2-4

- f. Which of the following is *not* explicitly included in an audit report with an unqualified opinion for a nonpublic company?

- (1) The CPA's opinion that the financial statements comply with generally accepted accounting principles.
- (2) That generally accepted auditing standards were followed during the audit.
- (3) That all material instances of fraud have been identified.
- (4) An identification of the financial statements audited.

LO 2-1

- g. Which of the following is not one of the forms of attestation presented in the AICPA *Statements on Standards for Attestation Services*:

- (1) Agreed-Upon Procedures.
- (2) Examination.
- (3) Inspection.
- (4) Review.

LO 2-7

- h. Which AICPA quality management standard is *most* associated with resolution of differences of opinion among staff members that may arise on an audit?

- (1) Governance and leadership.
- (2) Engagement performance.
- (3) Acceptance and continuance of client relationships and specific engagements.
- (4) Independence.

LO 2-3

- i. An audit provides reasonable assurance of detecting material

	Fraudulent Financial Reporting	Misappropriation of Assets
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

LO 2-5

- j. Which of the following is *not* included in an integrated audit report on the financial statements of a public company?

- (1) The report states that the audit was performed in accordance with AICPA standards.
- (2) The report indicates that the financial statements are the responsibility of management.
- (3) The report indicates that the auditors have also audited the effectiveness of the company's internal control.
- (4) The report is signed in the name of the CPA firm.

LO 2-1

- k. Audit firms that are subject to inspections by the PCAOB staff include

- (1) All audit firms.
- (2) Audit firms that are registered with the SEC.
- (3) Audit firms that are registered with the PCAOB.
- (4) Audit firms that are registered with a state board of accountancy.

LO 2-5

- l. An auditor has concluded that the financial statements are not fairly presented in that they are pervasively misstated. The most appropriate type of audit opinion is:

- (1) Adverse.
- (2) Disclaimer.
- (3) Qualified.
- (4) Unmodified.

(AICPA, adapted)

LO 2-7

2–33. Multiple Choice Questions

- a. A process ordinarily performed prior to the completion of an audit that emphasizes the significant judgments and conclusions made by the engagement team on an audit is referred to as a(n):

- (1) Completed engagement inspection.
- (2) Engagement quality review.
- (3) Judgment review engagement.
- (4) Peer review.

LO 2-7

- b. Engagement quality reviews are required for all audits performed under which standards?

	PCAOB	AICPA
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

LO 2-7

- c. Internally performed inspections of all completed engagements are required by:

	PCAOB	AICPA
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

LO 2-7

- d. A peer review of a CPA firm is most likely to be led by

- (1) A partner in the firm who is not otherwise involved in the audit.
- (2) A partner from a different CPA firm that is not otherwise involved in the audit.
- (3) PCAOB staff.
- (4) The Public Board of Peer Reviews.

LO 2-7

- e. An inspection performed by the PCAOB is least likely to include

- (1) An inspection and review of selected review engagements.
- (2) An evaluation of the documentation of the CPA firm's quality control system.
- (3) Tests of audit quality control procedures.
- (4) Consideration of the adequacy of compilation engagements.

LO 2-7

2–34. Multiple Choice Questions

- a. International Auditing and Assurance Standards Board pronouncements, as issued, apply to:

	Public Companies	Nonpublic Companies
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

LO 2-8

- b. International Standards on Auditing are issued by

	AICPA	IAASB
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

LO 2-9

c. *Generally Accepted Government Auditing Standards* are issued by the:

	AICPA ASB	PCAOB
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

LO 2-9

d. To which type(s) of governmental agencies may standards issued by the Government Accountability Office relate?

	Federal	State
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

LO 2-9

e. A primary difference in ERISA employee benefit plan audits is that in an ERISA section 103(a)(3)(C) audit, the auditors provide less assurance in their audit report relating to

- (1) Cash.
- (2) Accounts receivable.
- (3) Investment assets
- (4) Property, plant and equipment.

LO 2-9

f. In an ERISA audit, the auditors are required to report on whether ERISA-required schedules are fairly stated in all material respects, in relation to the:

- (1) Audit's unique assertions.
- (2) Company's Investment in each schedule.
- (3) Company's financial statements.
- (4) Plan's financial statements.

LO 2-4

2–35. **Simulation**

Casa Royale Inc., a public company, retains Ying and Company CPA to audit its financial statements and internal control. Howard Smythe, the partner in charge of the audit, drafted the following unqualified report:

Report of Independent Registered Public Accounting Firm (Comment a)

To the **shareholders and the board of directors (Comment b)** of Casa Royale, Inc.

Opinion on the Financial Statements

We have audited the accompanying balance sheets of Casa Royale, Inc. (the "Company"), as of December 31, 20X7 and 20X6, the related statements of income, comprehensive income, stockholders' equity, and cash flows, for each of the three years in the period ended December 31, 20X7, and the related notes (collectively referred to as the "financial statements"). In our opinion, the financial statements present fairly, in **all respects (Comment c)**, the financial position of the Company as of December 31, 20X7 and 20X6, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X7, in conformity with *accounting principles* generally accepted in the United States of America.

We also have audited, in accordance with standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the Company's internal control over financial reporting as of December 31, 20X7, based on Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and our report dated February 12, 20X8, expressed an unqualified opinion.

Basis for Opinion (Comment d)

These financial statements are the responsibility of the Company's management. Our responsibility is to express **reasonable assurance (Comment e)** on the Company's financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with **generally accepted auditing standards (Comment f)**. Those standards require that we plan and perform the audit to obtain reasonable assurance about

whether the financial statements are free of **all (Comment g)** misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matters

The critical audit matters communicated below are matters arising from the current period audit of the financial statements that were communicated or required to be communicated to the audit committee and that: (1) relate to **accounts that are material (Comment h)** to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

Ying and Company CPAs (Comment i)

Phoenix Arizona

(Comment j)

Respond as to the accuracy of the following comments made by a reviewer of the report:

Reviewer's Comments	Comment Is Correct (yes or no)
a. The report should not include the word "Registered."	
b. The report must also be addressed to management.	
c. The report should say in "all material respects."	
d. The Basis for Opinion section should precede the Opinion section.	
e. "Reasonable assurance" should be replaced by "an opinion."	
f. "Generally accepted auditing standards" should be replaced by "the standards of the PCAOB."	
g. "All" should be replaced by "material."	
h. "Accounts that are material" should be replaced by "accounts or disclosures that are material."	
i. "Ying and Company" should be replaced with "Howard Smythe," the engagement partner.	
j. The report should include a statement of when the firm began serving as the corporation's auditor.	

- LO 2-4** 2–36. State whether you agree (A) or disagree (D) with each of the following statements concerning the auditors' unqualified report of a public company.

Statement	Agree (A) or Disagree (D)
a. The report should begin with "CPA's Report" at the top.	
b. The report is ordinarily addressed "to whom it may concern."	
c. The report indicates that management is responsible for the preparation of the financial statements.	
d. The report indicates that the auditors' responsibility is to obtain particular assurance about whether the financial statements are free of material misstatements.	

e. The report ordinarily concludes on whether the financial statements are in conformity with generally accepted auditing standards.	
f. The report indicates that the audit involves performing procedures to assess the risks of material misstatement and performing procedures to respond to the risks.	
g. The report indicates that the audit evidence obtained is sufficient and appropriate to provide a basis for the audit opinion.	
h. The report indicates that the auditors consider and provide an opinion on compliance with major laws and regulations.	

- LO 2-4** 2–37. Wren, Inc., a nonpublic company, retains Ying and Company CPA to audit its financial statements and internal control. Sarah Smith, the senior on the audit, prepared the following first draft of an unmodified report:

Independent Registered Auditor's Report (Comment a)

To the Board of Directors and Management of Wren, Inc. (Comment b), Phoenix, AZ 85011

Opinion

We have audited the financial statements of Wren, Inc., which comprise the balance sheet as of December 31, 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of Wren, Inc. as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in accordance with Financial Accounting Standards Board (Comment c) accounting principles generally accepted in the United States of America.

Basis for Opinion

We conducted our audit (Comment d) in accordance with accounting (Comment e) standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of Wren, Inc. and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audit. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error. In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise significant (Comment f) doubt about Wren, Inc.'s ability to continue as a going concern for one year subsequent to issuance of these financial statements.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Accordingly, we are unable to obtain reasonable assurance that fraud will be detected. (Comment g) Misstatements are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users made on the basis of these financial statements.

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of Wren, Inc.'s internal control. Accordingly, no such opinion is expressed. **(Comment h)**
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about Wren, Inc.'s ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit.

Ying and Company, CPAs

Phoenix, Arizona February 3, 20X2 **(Comment i)**

(Comment j)

Respond as to the accuracy of the following comments made by a reviewer of the report:

Reviewer's Comments	Comment is Correct (yes or no)
a. Delete "REGISTERED."	
b. "Management" should not be included.	
c. Delete "Financial Accounting Standards Board."	
d. "Audit" should be replaced with "examination."	
e. "Accounting" should be replaced with "audit."	
f. "Serious" should be replaced with "Significant."	
g. The preceding sentence should be deleted.	
h. The preceding sentence should be deleted.	
i. The date should be year-end—December 31, 20X2	
j. The report is required to indicate the year in which we began serving as Wren, Inc.'s auditor.	

- LO 2-5** 2–38. Match each the following statements with the appropriate type of auditors' opinion (each auditors' report may be used once, more than once, or not at all):
- A. Adverse.
 D. Disclaimer.
 Q. Qualified.
 U. Unmodified.

Statement	Type of Audit Opinion
a. The auditors are unable to determine the overall fairness of the financial statements.	
b. This is the report most clients prefer.	
c. A limitation on the scope of the audit is significant, but not so pervasive as to overshadow an overall opinion.	
d. The financial statements are not fairly presented.	
e. A material departure from GAAP exists, but not so material as to pervasively misstate the financial statements.	

- LO 2-2** 2–39. State whether each of the following is or is not a principle (or a portion of a principle) underlying an audit conducted in accordance with generally accepted auditing standards.

Principles	Yes (Y) or No (N)
a. The purpose of an audit is to provide financial statement users with an opinion by the auditors on whether the financial statements are presented fairly, in all material and immaterial respects, in accordance with the applicable financial reporting framework.	
b. The auditors are responsible for having <i>appropriate competence and capabilities</i> to perform the audit.	
c. The auditors are unable to obtain absolute assurance that the financial statements are free from material misstatement.	
d. The opinion states whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.	
e. Inherent limitations of an audit include the need to conduct an audit to achieve a balance between the benefit to management and the benefit to the auditors.	

- LO 2-1, 2, 3, 4, 9** 2–40. For each term in the first column, select the partial (or complete) definition or illustration. Each partial (or complete) definition or illustration may be used only once.

Term	Partial (or Complete) Definition or Illustration
a. A report providing a summary of findings b. A report providing reasonable assurance c. An error d. An engagement quality review e. Financial reporting framework f. Fraud g. Inspection h. System of quality management i. Registered public accounting firm j. An ERISA section 103(a)(3)(C) audit k. A Single Audit	1. A CPA firm that may conduct only audits of public companies 2. A CPA firm that may conduct audits of public or nonpublic companies 3. Agreed-upon procedures report 4. Audit required for a nonprofit organization receiving \$1 million in federal financial aid 5. A review conducted by the PCAOB staff 6. An independent peer review 7. An unintentional misstatement 8. Audit report 9. Generally accepted accounting principles 10. Generally accepted auditing standard 11. An audit of an employee benefit plan 12. Reasonable assurance of fulfillment of responsibilities and issuance of appropriate engagement reports. 13. Independence and reasonable assurance 14. Misappropriation of assets 15. Review report 16. Evaluation of the significant judgments and conclusions made by the engagement team—completed before the engagement report is released.

Problems

LO 2-1, 2, 3

- 2–41. Joe Rezzo, a college student majoring in accounting, helped finance his education with a part-time job maintaining all accounting records for a small business, White Company, located near the campus. Upon graduation, Rezzo passed the CPA examination and joined the audit staff of a national CPA firm. However, he continued to perform all accounting work for White Company during his “leisure time.” Two years later, Rezzo received his CPA license and decided to give up his part-time work with White Company. He notified White that he would

no longer be available after preparing the year-end financial statements. On January 7, Rezzo delivered the annual financial statements as his final act for White Company. The owner then made the following request: “Joe, I am applying for a substantial bank loan, and the bank loan officer insists upon getting audited financial statements to support my loan application. You are now a CPA, and you know everything that’s happened in this company and everything that’s included in these financial statements, and you know they give a fair picture. I would appreciate it if you would write out an audit report with an unmodified opinion and attach it to the financial statements. Then I’ll be able to get some fast action on my loan application.”

- Would Rezzo be justified in complying with White’s request for an auditor’s opinion? Explain.
- If you think Rezzo should issue the audit report, do you think he should first perform an audit of the company despite his detailed knowledge of the company’s affairs? Explain.
- If White had requested an audit by the national CPA firm for which Rezzo worked, would it have been reasonable for that firm to accept and to assign Rezzo to perform the audit? Explain.

- LO 2-6** 2–42. Bart James, a partner in the CPA firm of James and Day, received the following memorandum from John Gray, president of Gray Manufacturing Corporation, an audit client of many years.

Dear Bart: I have a new type of engagement for you. You are familiar with how much time and money we have been spending in installing equipment to eliminate the air and water pollution caused by our manufacturing plant. We have changed our production process to reduce discharge of gases; we have changed to more expensive fuel sources with less pollution potential; and we have discontinued some products because we couldn’t produce them without causing considerable pollution. I don’t think the stockholders and the public are aware of the efforts we have made, and I want to inform them of our accomplishments in avoiding damage to the environment. We will devote a major part of our annual report to this topic, stressing that our company is the leader of the entire industry in combating pollution. To make this publicity more convincing, I would like to retain your firm to study what we have done and to attest as independent accountants that our operations are the best in the industry as far as preventing pollution is concerned. To justify your statement, you are welcome to investigate every aspect of our operations as fully as you wish. We will pay for your services at your regular audit rates and will publish your “pollution opinion” in our annual report to stockholders immediately following some pictures and discussion of our special equipment and processes for preventing industrial pollution. We may put this section of the annual report in a separate cover and distribute it free to the public. Please let me know at once if this engagement is acceptable to you.

Put yourself in Bart James’s position and write a reply to this client’s request. Indicate clearly whether you are willing to accept the engagement and explain your attitude toward this proposed extension of the auditor’s attest function.

In-Class Team Case

LO 2-3

2–43.



Hide-It (HI), a family-owned business based in Tombstone, Arizona, builds custom homes with special features, such as hidden rooms and hidden wall safes. Hide-It has been an audit client for three years. You are about to sign off on a “clean” unmodified opinion on HI’s current annual financial statements when Art Hyde, the VP-Finance, calls to tell you that the Arizona Department of Revenue has seized control of a Hide-It bank account that includes about \$450,000 of company funds; the account is not currently recorded in the accounting system and you had been unaware of it. In response to your questions about the origin of the funds, Art assures you that the funds, though not recorded as revenue, had been obtained legitimately. He explains that all of the money came from separately billed but unrecorded change orders to items in contracts completed before you became HI’s auditor, and before he or any members of current management became involved with the company. You subsequently determine that there is insufficient evidence to allow you to reconstruct the nature of these cash transactions, although the following analysis is available from the Arizona Department of Revenue:

Deposits 1/17/X2–12/3/X4	\$455,000
Interest earned 1/2/X2–12/31/X8	95,000
Withdrawals 2/12/X3–4/7/X7	<u>(100,000)</u>
Balance 12/31/X8	\$450,000

Art also informs you that HI has agreed to pay a combined tax and penalty of 12 percent on the total funds deposited within 120 days as required by a recently enacted rule that provides amnesty for tax evaders. Furthermore, he states that negotiations with the Internal Revenue Service are in process.

- a. The professional standards define errors as unintentional misstatements or omissions of amounts or disclosures in the financial statements. Is the situation described an error?
- b. The professional standards state that fraud relates to intentional misstatements or omissions of amounts or disclosures in the financial statements. Misstatements due to fraud may occur due to either (1) fraudulent financial reporting or (2) misappropriation of assets. Does the situation appear to be fraud? If so, is it fraudulent financial reporting, misappropriation of assets, or both?
- c. The professional standards outline certain auditor responsibilities relating to identifying client noncompliance with laws and distinguish between laws with a “direct effect” on the financial statements and other laws. Does the situation herein relate to noncompliance with laws as discussed within the auditing standards? If so, is the noncompliance related to a law with a direct effect on the financial statements or another law?
- d. Should the CPA firm resign in this situation? If the decision is not clear-cut, what additional information would you desire before deciding?

Research and Discussion Case



- 2–44. Enormo Corporation is a large multinational audit client of your CPA firm. One of Enormo’s subsidiaries, Ultro Ltd., is a successful electronics assembly company that operates in a small Caribbean country. The country in which Ultro operates has very strict laws governing the transfer of funds to other countries. Violations of these laws may result in fines or the expropriation of the assets of the company. During the current year, you discover that \$50,000 worth of foreign currency was smuggled out of the Caribbean country by one of Ultro’s employees and deposited in one of Enormo’s bank accounts. Ultro’s management generated the funds by selling company automobiles, which were fully depreciated on Ultro’s books, to company employees. You are concerned about this illegal act committed by Ultro’s management and decide to discuss the matter with Enormo’s management and the company’s legal counsel. However, Enormo’s management and board of directors seem to be unconcerned with the matter and express the opinion that you are making far too much of a situation involving an immaterial dollar amount. They also believe that it is unnecessary to take any steps to prevent Ultro’s management from engaging in illegal activities in the future. Enormo’s legal counsel indicates that the probability is remote that such an illegal act would ever be discovered, and that if discovery were to occur, it would probably result in a fine that would not be material to the client’s consolidated financial statements. Your CPA firm is ready to issue the integrated audit report on Enormo’s financial statements and internal control for the current year, and you are trying to decide on the appropriate course of action regarding the illegal act.



- a. Discuss the implications of this illegal act by Ultro’s management.
- b. Describe the courses of action that are available to your CPA firm regarding this matter.
- c. State your opinion as to the course of action that is appropriate. Explain.

Supplementary References

AICPA, *Professional Standards*, Volume 2, Commerce Clearing House, *Statements on Quality Management Standards*.

“Consideration of Fraud in a Financial Statement Audit,” AICPA AU-C 240 (PCAOB AS 2401).

“Consideration of Laws and Regulations in an Audit of Financial Statements,” AICPA AU-C 250 (PCAOB AS 2405).

FASB Accounting Standards Codification, section 450-20.

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Professional Ethics

All recognized professions have acknowledged the importance of ethical behavior and have developed codes of professional ethics. Our purpose in this chapter is to discuss the nature of professional ethics as well as to present and discuss the AICPA *Code of Professional Conduct*, the additional requirements for auditors of public companies, and the Institute of Internal Auditors *Code of Ethics*.

The Nature of Ethics

LO 3-1

Describe the nature of ethics and ethical dilemmas.

Ethics has been defined as the study of moral principles and values that govern the actions and decisions of an individual or group. While personal ethics vary from individual to individual at any point in time, most people within a society are able to agree about what is considered ethical and unethical behavior. In fact, a society passes laws that define what its citizens consider to be the more extreme forms of unethical behavior.

Much of what is considered unethical in a particular society is not specifically prohibited. So how do we know whether we are acting ethically? Who decides what standards of conduct are appropriate? Is any type of behavior “ethical” as long as it does not violate a law or a rule of one’s profession?

A good starting point for considering ethics is to examine the context in which most ethical questions arise—relationships among people. Any relationship between two or more individuals carries with it sets of expectations by each of the individuals involved. Certainly, the relationship between a certified public accountant (CPA) and a client offers a number of interesting challenges. For example: Is it ethical for a senior auditor to underreport the number of hours worked on an audit engagement? Is it ethical to accept tickets to a baseball game from an audit client? May a CPA ethically allow a client to pay for a business lunch and still maintain independence? Are there ethical issues involved in a situation in which a staff auditor wishes to date the controller of one of his firm’s audit clients? Does it matter whether the staff auditor works on that engagement?

What Are Ethical Dilemmas?

Ethical dilemmas often involve a mental conflict between differing moral requirements, in which to obey one requirement will result in disobeying another; the AICPA *Code of Professional Conduct* refers to these as **ethical conflicts**. Here is a simple example of an ethical dilemma:

Your company has a firm policy requiring employees to report any stolen company property of which they become aware. The company also has a policy of selling used equipment to a store that sells used equipment to the public. You just observed a close friend of yours take a used relatively small desktop printer from the pile of goods intended for the store. Your friend is only two months from retirement with the firm. The printer is slow and has a very limited value.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 3-1** Describe the nature of ethics and ethical dilemmas.
- LO 3-2** Describe a profession’s reasons for establishing professional ethics.
- LO 3-3** Discuss the Principles section of the American Institute of Certified Public Accountants (AICPA) *Code of Professional Conduct*.
- LO 3-4** Describe the applicability of the rules contained in the AICPA *Code of Professional Conduct* and the overall conceptual framework.
- LO 3-5** Explain the concept of independence and identify circumstances in which independence is impaired.
- LO 3-6** Contrast the independence rules for audits of public companies with those for audits of nonpublic companies.
- LO 3-7** Describe additional *Code of Professional Conduct* rules.
- LO 3-8** Discuss *Code of Professional Conduct* applicability to members not in public practice and describe overall *Code* enforcement.
- LO 3-9** Discuss the Institute of Internal Auditors’ ethical standards.

In this dilemma, you may have personal values of loyalty to friends, a belief that you should follow company policies, and a general feeling that situations should be handled fairly. Here you fear that reporting your friend's behavior will not only ruin your friendship, but may result in what you consider to be a disproportionate reaction by the company in terms of taking away certain benefits she will receive if she completes the two months remaining until retirement. Yet, you do believe that following company policy is important.

Ethical dilemmas faced by auditors often have an effect on the welfare of a large number of individuals or groups. As an example, assume that an auditor agrees that a vague, incomplete financial statement note disclosure related to a loss contingency is adequate, succumbing to the will of the client's CEO. As a result, the wealth of thousands of investors and creditors may be affected by this misleading disclosure. Yet, the CEO may be correct in his stated belief that it is very likely that the contingency briefly described in the note may never occur.

A Framework for Ethical Decisions

How do we make decisions about an appropriate course of action when faced with an ethical dilemma? As a starting point, let's consider how people make decisions in general. Certainly, many decisions require little conscious thought. The untied shoelace is quickly retied. The disposable pen that skips is quickly discarded and replaced. However, when the results of the decision have more significant consequences, a formal decision process is generally used. The steps involved in making any decision generally include

1. Identify the problem.
2. Identify possible courses of action.
3. Identify any constraints relating to the decision.
4. Analyze the likely effects of the possible courses of action on stakeholders.
5. Select the best course of action.

Various frameworks have been proposed for addressing ethical dilemmas.¹ However, because almost every decision faced by a CPA has an ethical dimension, it would appear to be appropriate to analyze ethical dilemmas using the general decision-making framework presented above. Let's illustrate the use of this framework in the following situation.

Making Ethical Decisions—A Professional Example

Assume that you have worked for a public accounting firm for approximately six months, and you were recently assigned to the audit of a small manufacturing company. The senior auditor on the job assigned you the task of extracting financial information about comparable companies from several financial databases on the Internet. She indicated that the work must be completed by Monday morning. While you had hoped to complete the assignment on Friday, things didn't work out and you had to come to work on Saturday.

On Saturday, your expectation that it would take only a couple hours to complete the task faded and you didn't finish until 4 p.m., after eight hours of work. You believe that part of the problem was that you were out late Friday night at a Kings of Leon concert and you just weren't all that efficient. Although you completed the task, you exceeded the budgeted hours for the task by six hours. Because of the circumstances (inefficient work and the blown budget), you are tempted to underreport the number of hours (informally known as "eating hours") that you actually worked. While your firm has a policy that states that employees should report all hours worked, you are aware that the policy is often ignored by other staff auditors. In addition, you are aware that your evaluation on this audit will be based not only on the quality of your work, but also on your ability to

¹ For a description of models that have been suggested for use to resolve ethical dilemmas faced by professionals, see Howard Brody, *Ethical Decisions in Medicine*, 2nd ed. (Boston: Little, Brown and Company, 1981).

meet time budgets. You have been criticized on your evaluations on previous engagements for taking too long to perform certain tasks.

Because you are paid a straight monthly salary and a year-end bonus based on performance, your pay will not be directly affected by underreporting the hours worked. You could even argue that not reporting the hours might improve your evaluation and lead to a bigger bonus.

Now, let's analyze this ethical dilemma using the decision-making framework previously presented.

1. *Identify the problem.* The problem in this case is that you have exceeded the time budget for your assigned task.
2. *Identify possible courses of action.* Although there are any number of options for reporting the number of hours worked, for simplicity's sake let's assume that you are considering only two: (1) reporting only two of the eight hours worked on Saturday to exactly meet the budget or (2) reporting all eight hours.
3. *Identify any constraints relating to the decision.* Ethical dilemmas such as this one frequently involve both internal and external standards that serve as constraints. Internal standards may be the result of your religious or other beliefs about the manner in which you should behave and make decisions. These standards involve such concepts as truthfulness, fairness, loyalty, and caring for others. Perhaps you believe that one must be absolutely truthful in every situation; alternatively, you might believe that in certain circumstances absolute truthfulness is not necessary. As an example, some people might believe that caring for others is sometimes more important than telling the truth. They might decide that it is not proper to tell patients with heart failure that they are unlikely to survive the night, even if they ask. Some people's concepts of loyalty and fairness might also prevent them from being completely truthful in all cases.

External standards are those that are imposed upon an individual by society, peers, organizations, employers, or their profession. In this circumstance, the relevant external standards include the informal firm policy about reporting time and the AICPA *Code of Professional Conduct*, which requires "integrity" on the part of CPAs.

4. *Analyze the likely effects of the possible courses of action on stakeholders.* Because ethical dilemmas ordinarily affect individuals who are not involved in the decision-making process, this step involves considering the implications of the various courses of action on both the individual involved and any other stakeholders affected by the decision. Also, it is important to consider both the short-term and the long-term effects. The following table presents these considerations as they apply to the two alternative courses of action in this situation.
5. *Select the best course of action.* You are the only one who can determine how to respond in situations such as this. The individual whose utmost consideration is career advancement may believe that underreporting the time is the solution. However, that individual should realize that in the long run they may be "caught" and the negative reaction by the firm could be extreme. Alternatively, the individual with the simple rule "tell the truth" has the obvious solution of reporting all the hours.

Discussion

This ethical dilemma is constructed to illustrate the steps involved in making a professional decision. It is simplified in that the CPA could realistically decide to report any number of hours between zero and eight. Notice that one might attempt to "rationalize" underreporting some time by focusing on the inefficiency of the work and the inappropriateness of charging the client for this inefficiency. Another solution to this dilemma would be to charge the hours but make it clear in a note to the senior auditor that you do not believe it fair to charge the client for some of the hours because of your inefficiency.

Alternative 1: Report Only Two Hours		
Effect on:	Positive Effects:	Negative Effects:
You	• Performance evaluation may be improved • Bonus may be positively affected	• Is inconsistent with AICPA <i>Code of Professional Conduct</i> • Is not consistent with firm policy and may result in termination • Action is dishonest
The CPA firm		• Policy is violated • Possible underbilling of the client • May encourage the development of unrealistic budgets in the future that may affect the morale of employees and could lead to substandard performance of audits • Underreporting of time on a large scale may adversely affect the firm's ability to attract and retain employees
Other staff	• The senior auditor may be positively evaluated by completing the job on budget	• May lead to the development of unrealistic budgets that adversely affect morale and lead to improper performance evaluations or force staff to underreport time
The client	• May lead to a lower total audit fee (particularly if combined with other underreporting of time)	• May cause substandard audits in the future if staff members struggle to meet unrealistic budgets
Alternative 2: Report All Eight Hours		
Effect on:	Positive Effects:	Negative Effects:
You	• Action is truthful • Consistent with informal firm policy • Consistent with AICPA <i>Code of Professional Conduct</i>	• Performance evaluation may be negatively affected • Bonus may be negatively affected
The CPA firm	• Results in proper billing of client • More realistic budgets may be developed in the future	
Other staff	• More realistic budgets may lead to higher morale	• Senior auditor may be negatively evaluated due to budget overrun
The client	• May lead to better audits as staff auditors will be given more realistic budgets in the future	• May lead to a higher (though more accurate) audit fee

While this dilemma had a “correct” answer of eight hours, many other decisions involve “gray areas,” where there are no obvious answers. For example, consider the case in which the auditors are engaged by management of a company to evaluate the appropriateness of an accounting method that is being used to account for certain transactions. Presumably, if the auditors agree with management’s accounting method, they will be engaged to audit the company. In researching the issue, the auditors find that no accounting standards specifically apply. While the auditors believe that there is justification for management’s method of accounting, they believe that another method may be more acceptable. Yet, the financial statements are those of management. This is clearly an ethical dilemma in which there is no definitive answer. Nonetheless, in a situation in which auditors believe that management’s method cannot be justified and sacrifice their principles to obtain the audit engagement, they are not playing a very valuable role in society and are violating professional ethics.

The above examples show that an individual's self-interest may be inconsistent with acting in accordance with their ethical beliefs. This is often the case in many of the ethical dilemmas that are faced by individuals as well as professional accountants.

The purpose of the remainder of this chapter is to discuss the requirements of the AICPA *Code of Professional Conduct* and The Institute of Internal Auditors *Code of Ethics*. In addition, we will describe the additional requirements for auditors of public companies. These requirements attempt to provide auditors with a minimum set of standards for making ethical decisions. They cannot, however, address all situations, and the auditors often are called on to use professional judgment to make decisions in ethically perplexing situations.

The Need for Professional Ethics

LO 3-2

Describe a profession's reasons for establishing professional ethics.

To understand the importance of a code of ethics to public accountants and other professionals, one must understand the nature of a profession as opposed to other vocations. There is no universally accepted definition of what constitutes a profession; yet, for generations, certain types of activities have been recognized as professions while others have not. Medicine, law, engineering, architecture, and theology are examples of disciplines long accorded professional status. Public accounting is a relative newcomer to the ranks of the professions, but it has achieved widespread recognition in recent decades.

All the recognized **professions** have several common characteristics. The most important characteristics are (1) a responsibility to serve the public, (2) a complex body of knowledge, (3) standards of admission to the profession, and (4) a need for public confidence. Let us briefly discuss these characteristics as they apply to public accounting.

Responsibility to Serve the Public

The certified public accountant is a representative of the public—creditors, stockholders, consumers, employees, and others—in the financial reporting process. The role of the independent auditor is to ensure that information is *fair to all parties* and not biased to benefit one group at the expense of another. This responsibility to serve the public interest must be a basic motivation for the professional. Public accountants must maintain a high degree of independence from their clients if they are to be of service to the larger community. Independence is perhaps the most important concept embodied in public accounting's *Code of Professional Conduct*.

Complex Body of Knowledge

Any practitioner or student of accounting has only to look at the abundance of authoritative pronouncements governing financial reports to realize that accounting is a complex body of knowledge. One reason such pronouncements continue to proliferate is that accounting must reflect what is taking place in an increasingly complex environment. As the environment changes—such as the trend toward business reorganizations beginning in the 1980s through today—accounting principles and auditing practices must adapt. The continual growth in the “common body of knowledge” for practicing accountants has led the AICPA and other professional and regulatory bodies to enact continuing education requirements for CPAs. The need for technical competence and familiarity with current standards of practice is embodied in the *Code of Professional Conduct*.

Standards of Admission to the Profession

Attaining a license to practice as a certified public accountant requires an individual to meet minimum standards for education and experience. The individual also must pass the uniform CPA examination showing mastery of the body of knowledge described above. Once licensed, certified public accountants must adhere to the ethics of the profession or risk disciplinary action.

Need for Public Confidence

Physicians, lawyers, certified public accountants, and all other professionals must have the confidence of the public to be successful. To the CPA, however, public confidence

is of special significance. The CPA's product is credibility. Without public confidence in the attestor, the attest function serves no useful purpose.

Professional ethics in public accounting as in other professions have developed gradually and are still in a process of change as the practice of public accounting itself changes. Often new concepts are added as a result of unfortunate incidents that, though they reflect unfavorably upon the profession, may not specifically violate existing standards.

Professional Ethics in Public Accounting

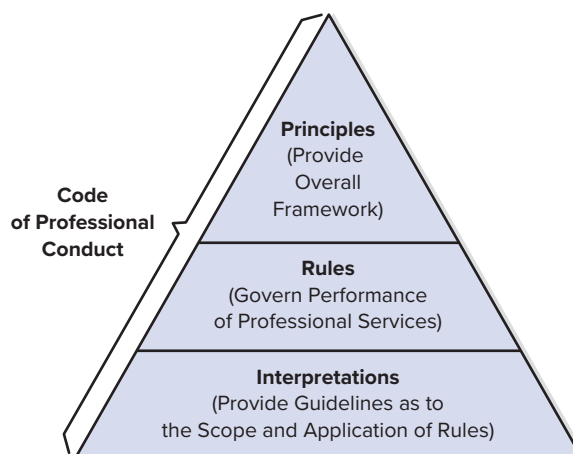
Careless work or lack of integrity on the part of any CPA may lead the public to a negative view toward the entire profession. Consequently, the members of the public accounting profession acted in unison through the AICPA to develop a code of conduct. This code provides practical guidance to the individual member in maintaining a professional attitude. In addition, this code is designed to provide assurance to clients and to the public that the profession intends to maintain high standards and to enforce compliance by individual members.

Concerns about the credibility of audits, as discussed in Chapter 1, caused Congress to question the AICPA's ethical rules and enforcement processes. As a result, the Public Company Accounting Oversight Board (PCAOB) was given the authority to develop and enforce ethical rules for audits of public companies. It chose to adopt as interim standards the AICPA rules, interpretations, and rulings relating to independence, integrity, and objectivity as those requirements existed on April 16, 2003. It did not adopt the remainder of the AICPA *Code of Professional Conduct*. In general, the PCAOB requirements relating to independence, integrity, and objectivity do not differ significantly from those of the AICPA, with the exception of the requirements relating to the types of nonattest services that may be performed for audit clients. We discuss those differences in this chapter.

The AICPA Code of Professional Conduct—Overall Structure

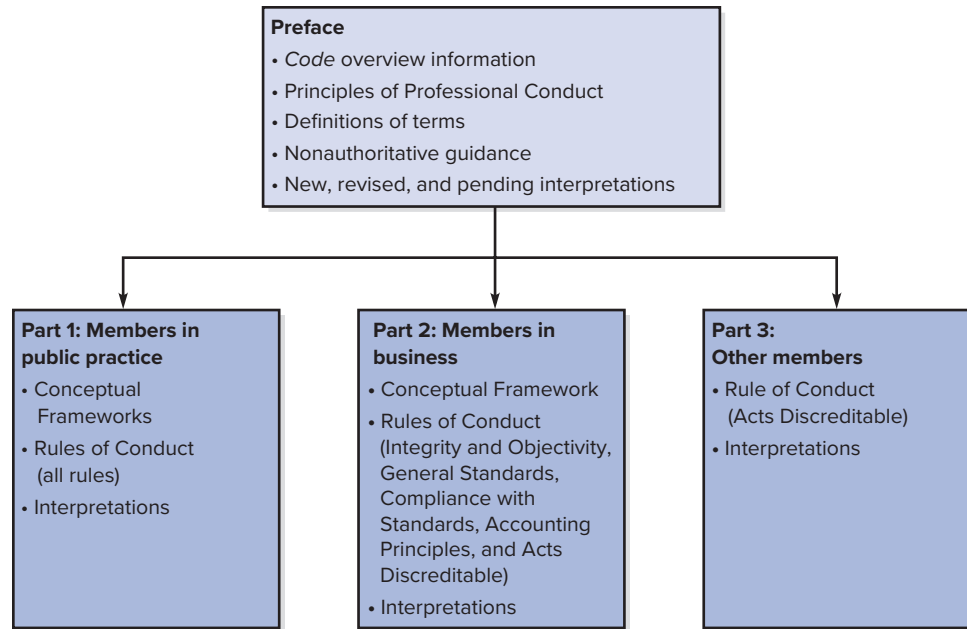
The AICPA *Code of Professional Conduct* (the *Code*), adopted in 2014, provides guidance and rules to CPAs in the performance of their professional responsibilities. It consists of principles, rules, interpretations, and other guidance.² The **principles** are goal-oriented, positively stated statements on the profession's responsibilities to the public, clients, and fellow practitioners. The principles provide the framework for the **rules**, which are the requirements that are enforceable under the AICPA bylaws. The AICPA's Professional Ethics Executive Committee issues **interpretations** to provide guidelines for the scope and application of the rules. A member of the AICPA who departs from a rule or an interpretation has the burden of justifying such departure. Figure 3.1 summarizes the relationships among the principles, rules, and interpretations. Other guidance includes information such as the organization of the *Code*, definitions, and pending revisions.

FIGURE 3.1
Relationships of Principles, Rules, and Interpretations in *Code of Professional Conduct*



² The 2014 *Code* is in large part a restructuring of the previous *Code*, which was originally adopted in 1988 and revised a number of times since its adoption. The goals of the new *Code* are to create guidance for applying the rules and reaching correct conclusions more easily and intuitively.

FIGURE 3.2
Sections of AICPA Code
of Professional Conduct



The *Code* includes

- Preface.
- Part 1: Applicable to members in public practice.
- Part 2: Applicable to members in business.
- Part 3: Applicable to all other members, such as those retired or unemployed.

The AICPA *Code of Professional Conduct* may be accessed online, currently at no cost. You may use a search engine such as Google to access the *Code*. Alternatively, as we go to press, the *Code* is available at <https://pub.aicpa.org/codeofconduct/Ethics.aspx>.

The solutions for a number of questions and problems at the end of the chapter explicitly require use of the *Code*. For others, using the *Code* is one of several ways of obtaining a solution.

Figure 3.2 presents an outline of the overall *Code* and major components included in each. In this chapter, we emphasize the Preface and Part 1. We also provide summaries of Parts 2 and 3.

Preface of Code of Professional Conduct

LO 3-3

Discuss the Principles section of the American Institute of Certified Public Accountants (AICPA) *Code of Professional Conduct*.

The preface initially presents overview information on the *Code*. It makes clear that the rules of conduct apply to all professional services performed except when the wording of the rule indicates otherwise and in certain circumstances when services are provided outside of the United States. The preface then presents the principles. The principles, presented in Figure 3.3, address the profession's recognition of its responsibilities to the public, to clients, and to colleagues.

The preface also includes definitions of terms used in the *Code*, information on nonauthoritative guidance,³ and new, revised, and pending interpretations. The primary terms used in the *Code* are included in the list of key terms at the end of this chapter. Finally, the preface includes recent changes in the *Code*.

³ The AICPA *Code of Professional Conduct* is the only authoritative source of AICPA ethics rules and interpretations. Nonauthoritative guidance, often in the form of "Frequently Asked Questions" and "Basis for Conclusion Documents," is issued by the Professional Ethics Division to assist members and others in implementing the *Code*. The nonauthoritative guidance is not meant to be exhaustive and does not necessarily establish best practices or set standards because such guidance does not follow normal AICPA due process requirements (e.g., public exposure prior to issuance). When considering nonauthoritative guidance, the CPA generally has more latitude in exercising independent, professional judgment in its implementation and execution than is the case with authoritative guidance.

FIGURE 3.3 AICPA *Code of Professional Conduct* Principles

Principle Title	Principle
Responsibilities	In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.
The Public Interest	Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate a commitment to professionalism.
Integrity	To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.
Objectivity and Independence	A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.
Due Care	A member should observe the profession's technical and ethical standards, strive to continually improve competence and the quality of services, and discharge responsibility to the best of the member's ability.
Scope and Nature of Services	A member in public practice should observe the Principles of the AICPA <i>Code</i> in determining the scope and nature of services to be provided.

Rules and Conceptual Frameworks of Code of Professional Conduct

LO 3-4

Describe the applicability of the rules contained in the AICPA *Code of Professional Conduct* and the overall conceptual framework.

In addition to providing principles, rules, and interpretations, the *Code* also presents conceptual frameworks that address threats to compliance with the *Code* when the *Code* itself contains no specific related guidance. Separate, but very similar, frameworks are presented for

- Compliance with the overall *Code* (one framework for those in public practice and one for those in business).
- Compliance with independence requirements (for those in public practice with attest clients).

Rules

The titles of the rules of the *Code* are presented in Figure 3.4—a detailed discussion of each rule follows later in this chapter. Note that while all rules apply to CPAs in public practice, some of the rules do not apply to CPAs in business and other CPAs (e.g., retired, unemployed). As indicated in Figure 3.2, the *Code* includes separate sections pertinent to CPAs who fall under each of these three groups of members. Our discussion emphasizes requirements for CPAs in public practice and the following sections of this chapter are structured around the various rules.

Conceptual Frameworks

Because it is impossible to enumerate all of the circumstances and relationships that may result in a situation in which there is a risk of noncompliance with the *Code*, the *Code* includes Conceptual Frameworks to address situations not directly addressed. Two conceptual frameworks are included for CPAs in practice (one for the overall *Code* other than independence and one for independence) and one for CPAs in business. Figure 3.5 presents the conceptual framework for compliance with the overall *Code* for CPAs in public practice.

When one or more circumstances or relationships are identified that create a situation that potentially might be viewed as a **threat** to *Code* compliance, the first step is to determine whether the *Code* directly resolves the situation. If the *Code* directly sets forth requirements for a particular circumstance or relationship, the issue is resolved—the

FIGURE 3.4 Applicability of AICPA Code of Professional Conduct: Rules

Rules	Public Practice	Business	Other
Integrity and Objectivity	X	X	
Independence	X		
General Standards	X	X	
Compliance with Standards	X	X	
Accounting Principles	X	X	
Acts Discreditable	X	X	X
Fees and Other Types of Remuneration			
• Contingent Fees	X		
• Commissions and Referral Fees	X		
Advertising and Other Forms of Solicitation	X		
Confidential Client Information	X		
Form of Organization and Name	X		

Note: An X indicates that standards related to the rule apply to members in the particular group of public practice, business, or other.

Code should be followed. For example, the Contingent Fees Rule of the *Code* prohibits a member from receiving a contingent fee from an attest client (e.g., 5% of a client's net income as an audit fee). In such a circumstance, no further consideration is required—the member should not accept such a fee.

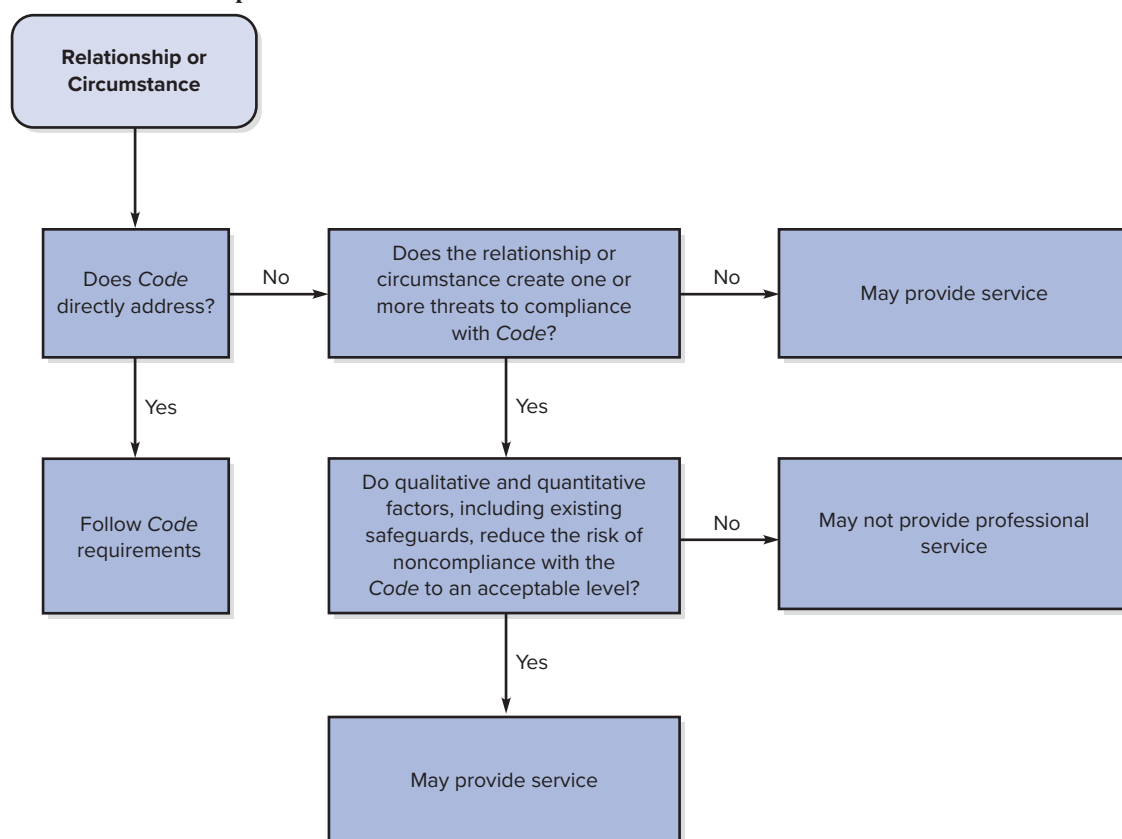
FIGURE 3.5 Conceptual Framework for Members in Public Practice: Evaluating Threats to *Code* Compliance

FIGURE 3.6 Broad Categories of Threats to Compliance with Rules

Threat	Summarized Definition	Public Practice Examples
Adverse interest	Accountant will not act with objectivity because of interests opposed to the client's interests.	1. Threatened or actual litigation between accountant and a client.
Advocacy	Accountant will promote a client's interests or position and compromise objectivity or independence.	1. Promoting a client's securities. 2. Endorsing a client's services or products.
Familiarity	Accountant will become too sympathetic to the client's interests or too accepting of client's work or product due to a long or close relationship.	1. Accountant's immediate family, close relative, or friend is employed by client. 2. A former partner or professional employee joins the client in a key position and has knowledge of CPA firm's policies and practices.
Management participation	Accountant will take on the role of client management or otherwise assume management responsibilities.	1. Accountant assumes a client's role while performing nonaudit services.
Self-interest	Accountant could benefit, financially or otherwise, from an interest in, or relationship with, a client.	1. Accountant has a financial interest in a client, and the outcome of an engagement may affect the value of the interest. 2. Accountant's spouse enters into employment negotiations with a client. 3. Accountant excessively relies on revenue from a single client.
Self-review	Accountant will not appropriately evaluate results of a previous judgment made or service performed or supervised by the accountant or the accountant's firm.	1. Accountant performs bookkeeping services for a client. 2. A partner in the member's office was associated with the client as an employee, officer, director, or contractor.
Undue influence	Accountant will subordinate judgment to that of an individual associated with a client due to client's reputation, expertise, dominant personality, or attempts to coerce or excessively influence the accountant.	1. CPA firm is threatened with dismissal. 2. An individual associated with a client threatens to withdraw or terminate a professional service unless the accountant reaches certain judgments or conclusions.

If the *Code* does *not* directly address a situation, the CPA should evaluate whether the circumstance or relationship creates one or more threats to compliance with the *Code*—Figure 3.6 presents categories of threats. When a threat exists, its significance should be evaluated to determine whether an **acceptable level of risk of noncompliance** with the *Code* exists. A threat is at an acceptable level when a reasonable and informed third party who is aware of the relevant information would be expected to conclude that the threat would not compromise the member's compliance with the *Code*. Members should consider qualitative and quantitative factors when evaluating the significance of a threat, including the extent to which existing safeguards already reduce the threat to an acceptable level.

Safeguards are controls that mitigate or eliminate threats to independence. For members in practice, there are three broad categories of safeguards:

- Safeguards created by the profession, legislation, or regulation (e.g., education requirements, and competency requirements for professional licensure).

- Safeguards implemented by the attest client (e.g., management with suitable skills and experience to make managerial decisions, or effective oversight by an independent board of directors).
- Safeguards put in place by the CPA firm, including policies and procedures for implementing professional and regulatory requirements (e.g., firm leadership that stresses the importance of complying with the rules, internal policies and procedures designed to monitor compliance with firm policies and procedures, and a disciplinary mechanism designed to promote compliance with policies and procedures).

After considering the facts and circumstances, including any safeguards, the CPAs make a final decision about whether the threat is at an acceptable level.

Ethical Conflicts

Earlier in this chapter we discussed ethical dilemmas. The *Code* acknowledges the existence of ethical dilemmas (it refers to them as ethical conflicts). It suggests that in such circumstances, the CPA should consider factors such as (1) relevant facts and circumstances (including laws or regulations), (2) ethical issues involved, and (3) established internal procedures. As discussed earlier in this chapter, these situations are difficult. The CPA faced with an ethical dilemma should consider consulting appropriate persons within or outside the firm. The CPA also should consider documenting the substance of the conflict, the parties with whom the issue was discussed, details of any discussions, and decisions made concerning the dilemma.

Code of Professional Conduct: Applicability to Members in Public Practice

In the following sections, we discuss the various *Code* rules as they apply to accountants in public practice. Following these sections are brief discussions of responsibilities of CPAs in business and those in neither practice nor business (ordinarily retired or unemployed).

Independence

LO 3-5

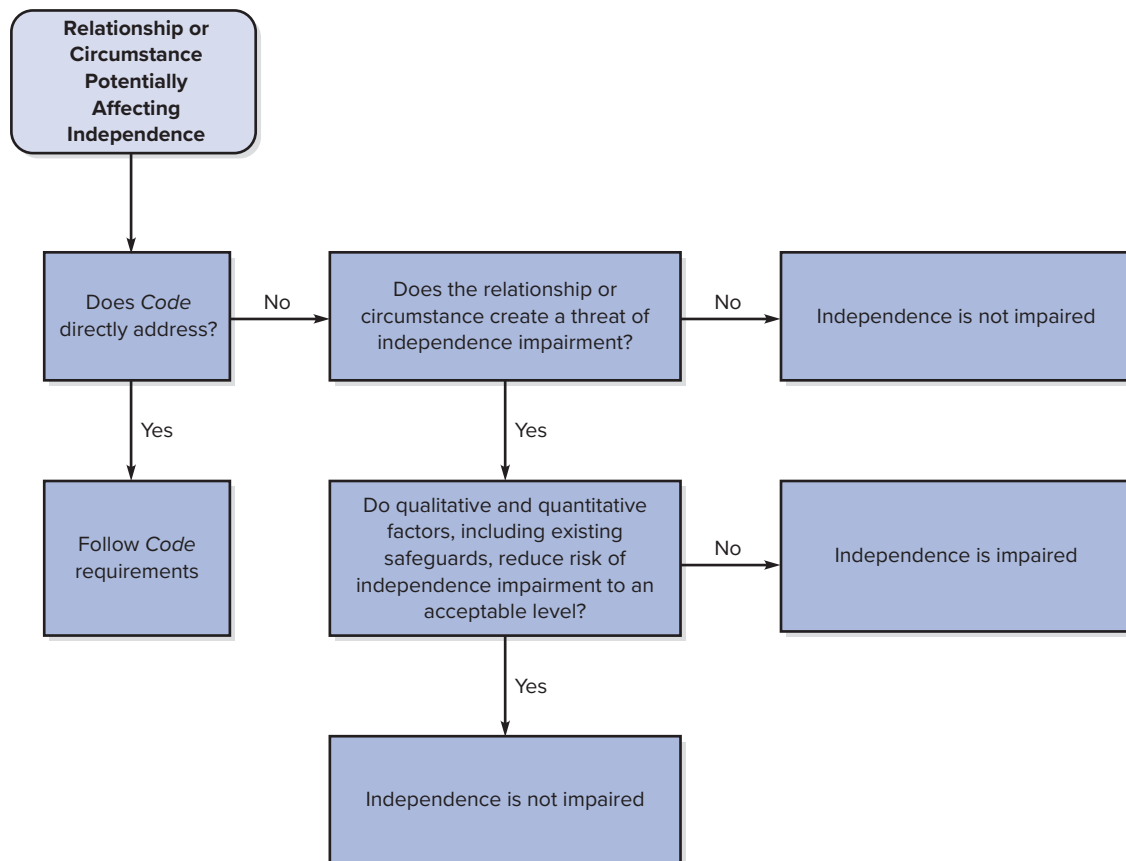
Explain the concept of independence and identify circumstances in which independence is impaired.

Independence Rule: A member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council.

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CPA firm independence from a client is required when providing audit and other attestation and assurance services. If the CPA firm does not perform these services for a client, independence is not required. As an example, if a CPA only performs consulting services for a client, the CPA need not be independent of that client. Therefore, our comments below regarding independence apply to CPAs in public practice when they perform any audit or other attestation service for a client.

The public accounting profession acknowledges the critical importance of **independence** of accountants who perform attestation services, independence of both mind and appearance. **Independence of mind** is a state of mind that permits the CPA to perform an attest service without being affected by influences that might compromise professional judgment, thereby allowing that individual to act with integrity and to exercise objectivity and professional skepticism. **Independence in appearance** requires the avoidance of circumstances that might cause a reasonable and informed third party, aware of all relevant information, including safeguards applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of an audit firm or member of the attest engagement team has been compromised.

FIGURE 3.7 Conceptual Framework for Members in Public Practice: Evaluating Threats to Independence

The rules and interpretations specifically address and resolve issues relating to independence (or the lack thereof) in many situations. In addition, the *Code* adapts the earlier framework and the threats that apply in general to code compliance (Figures 3.5 and 3.6) to independence by modifying the terminology involved and, in the case of threats, providing independence-related issues—Figures 3.7 and 3.8 present this guidance.

Similar to the general framework presented earlier in this chapter in Figure 3.5, safeguards for independence arise from

- Safeguards created by the profession, legislation, or regulation.
- Safeguards implemented by the attest client.
- Safeguards implemented by the CPA firm.

Individual vs. Firm Impaired Independence and the Nature of Covered Members

Two particularly important concepts related to independence are (1) individual accountant **impaired independence** versus firm impaired independence⁴ and (2) the nature of **covered members**.

Independence concerns exist at both the individual accountant and the public accounting firm levels; one, both, or neither may lack independence with respect to a client or potential client. A public accounting firm does not necessarily lose independence with respect to an engagement when one or more of its employees or partners are not independent. For example, if a professional employee of a public accounting firm owns stock in a company, that employee is not independent. The public accounting firm may or may not be considered independent based on a consideration of additional factors.

⁴ The *Code of Professional Conduct* uses the word “impaired” (e.g., impaired independence, independence is impaired) to describe situations in which either the accountant, the accountant’s firm, or both are not independent. In this chapter, we use that term and “not independent” interchangeably.

FIGURE 3.8 Broad Categories of Threats to Independence

Threat	Definition	Examples
Adverse interest	Actions between the public accountant and the client that are in opposition	1. Threatened or actual litigation between the public accountant and the client
Advocacy	Actions promoting an attest client's interest or position	1. Promoting client securities as part of an initial public offering 2. Representing a client in U.S. Tax Court
Familiarity	Accountants having a close or long-standing relationship with client personnel	1. A spouse or close friend holds a key position with the client (e.g., chief executive officer) 2. A partner or partner equivalent has provided attest services for a prolonged period 3. An accountant for the CPA firm recently was a director or officer at the client firm
Management participation	The accountant taking on the role of client management or otherwise performing management functions	1. Serving as an officer or director of the client 2. Establishing and maintaining internal controls for the client 3. Hiring, supervising, or terminating the client's employees
Self-interest	A potential benefit to the accountant from a financial interest in, or some other financial relationship with, an attest client	1. Having a direct financial interest or a material indirect financial interest in the client 2. Having a loan from the client 3. Excessive reliance on revenue from a single attest client 4. Having a material joint venture with the client
Self-review	As a part of an attest engagement, using evidence that results from the firm's non-attest work	1. The CPA firm has provided nonaudit services relating to the information system and the accountant is now considering results obtained from that information system in the audit
Undue influence	An attest client's management coerces the public accountant or exercises excessive influence over the accountant	1. Threat to replace firm over a disagreement on the application of an accounting principle 2. Pressure to reduce audit procedures for the purpose of reducing audit fees 3. A gift from the client that is other than clearly insignificant

In understanding CPA firm independence, it is critical to understand the concept of a covered member—in general, if a covered member's independence is impaired with respect to an attest client, the firm's independence is also impaired. A covered member is an individual, firm, or entity that is capable of influencing an attest engagement. Covered members include:

- An individual on the **attest engagement team**.
- An **individual in a position to influence the attest engagement** (e.g., a partner who directly supervises the partner who is in charge of the attest engagement).
- A partner or **partner equivalent**⁵ in the office in which the partner in charge of the attest engagement primarily practices in connection with the attest engagement.
- Certain partners, partner equivalents, or **managers** who provide nonattest services to the client.

⁵ A partner equivalent is a professional employee who is not a partner but has the ultimate responsibility for an attest engagement or has the authority to bind the CPA firm to conduct an attest engagement without partner approval. For example, assume a CPA firm employee is a manager who functions as a partner in that she has ultimate responsibility for several engagements—this employee is a partner equivalent.



Illustrative Case

Friendships with Clients

The very nature of working with a client while providing professional services may result in the development of friendships between client and audit firm personnel. This is considered a normal part of business. But at a certain point, these friendships may lead to situations in which possible impairment of auditor independence becomes an issue.

As shown in Figure 3.8, familiarity is an issue, in that accountants having a close or long-standing relationship with client personnel is considered a threat. In concept, the issue can only be resolved when there are adequate safeguards to address the situation.

Two enforcement actions by the Securities and Exchange Commission may illustrate threats to auditor independence. One Big 4 CPA firm, without admitting or denying SEC findings, agreed to pay over \$9 million to settle two actions in which the Commission suggested that the firm's ability to perform independent audits was in question due to close personal relationships.

In the first action, the CPA firm's lead audit partner on the engagement was tasked with improving the firm's relationship with a client that was considering switching to another CPA firm. The partner developed a close personal relationship with the CFO and members of the CFO's family. In addition to various local social activities, the partner and the CFO went on at least seven out-of-town trips together (sometimes including the partner's wife and members of the CFO's family). A number of the

activities involved attending sporting events, including a Masters golf tournament, professional hockey games, and professional football games. In total, the partner spent over \$100,000 on entertainment-related expenses hosting the CFO and his family over a three-year period.

In the second action, a CPA firm engagement partner on the audit had a romantic relationship with the client's chief accounting officer. The relationship was described by the SEC as "being marked by a high level of personal intimacy, affection and friendship, near daily communications about personal and romantic matters . . ." A partner who supervised the audit became aware of facts relating to the "improper relationship" but failed to perform a reasonable inquiry or raise the issue internally within the CPA firm.

In addition to penalties assessed against the CPA firm, the three partners were censured by the SEC and denied the privilege of practicing before the Commission as accountants. None of them currently work for the CPA firm.

These actions certainly raise a question as to what type and how many interactions are appropriate between a client and the auditors—even auditors at the beginning staff level. When does independence become impaired? How many events spent together are too many? When does a potentially romantic attraction become a problem? While creation of specific standards seems impossible, perhaps the key is to have enough self-awareness to know when you have wandered too far into a gray area and try to step back from it, or inform CPA firm personnel about your concerns.

- The public accounting firm, including its employee benefit plan.
- Any entity controlled by one or more of the above.⁶

All CPA firm partners and employees have a number of restrictions relating to attest clients. But it is covered members who have the most stringent requirements relating to financial, business, and other relationships with a client because when a covered member's independence on a particular attest engagement is impaired, the firm's independence is impaired and it may not perform the attest engagement. The following three sections discuss situations in which the lack of independence of an individual CPA may impair firm independence. It is organized to clearly present (1) requirements for all partners and staff, (2) additional requirements for covered members, and (3) overall firm requirements.

Independence Requirements for All Partners and Staff

As indicated earlier, all CPA firm partners and professional employees are under a number of restrictions relating to attest clients. Two primary requirements relate to overall investments in those clients and to employment status. First, no partner or professional employee of the CPA firm or immediate family may own more than five percent of an attest client's outstanding equity securities during the **period of the professional engagement**.⁷ Furthermore, no group of persons acting together (e.g., a group of partners who form an "investment club") may own more than five percent. If more than five

⁶ Informally, covered members include (a) the attest engagement team, (b) all partners in the engagement office, (c) individuals able to influence the engagement, (d) the firm itself, and (e) certain others.

⁷ In general, the period of the professional engagement begins when the CPA firm signs an initial engagement letter (or other agreement) and concludes upon termination of the professional relationship.

percent is so owned, independence of the firm is impaired—accordingly, the firm may not perform attest services for the client.

Concerning employment status, if a partner or professional employee of the CPA firm is simultaneously associated with the CPA firm and the client as a director, officer, employee, promoter, trustee, etc., CPA firm independence is impaired. For the firm to be independent, CPAs who were previously employed by the client must disassociate themselves from that client and must not participate in audits of any periods during which they were employed by the client. The firm remains independent of the client (even if the individual is a partner), but the individual CPA is not independent.

Additional Independence Requirements for Covered Members

As indicated earlier, the independence of covered members with respect to attest clients is particularly important to CPA firms—in general, if a covered member's independence is impaired, the firm's independence is impaired. Although there are many circumstances and relationships that potentially affect the independence of covered members, we summarize the following particularly important circumstances and relationships:

- Financial relationships.
- Effect of family and friends.
- Future employment with a client.
- Gifts.

Financial Relationships of Covered Members

The *Code* restricts the financial interests that a covered member may have either in the client itself or with client personnel. A **financial interest** is an ownership interest in an equity or a debt security issued by an entity; such an interest may be either direct or indirect. A **direct financial interest** includes an investment in the client, such as owning capital stock or providing loans to the client. An **indirect financial interest** generally involves an intermediary of some sort; for example, assume that a CPA invests in a mutual fund, which in turn owns stock in a client of that CPA. The CPA's portion of that investment in the attest client is the indirect financial interest. Concerning direct and indirect financial relationships of covered members:

- *All direct* financial interests are prohibited, regardless of amount.
- *Material indirect* financial interests are prohibited.

The above restrictions begin with the period of the professional engagement. Accordingly, when a public accounting firm acquires a new attest client, those who will become covered members must dispose of any prohibited financial or other interests on a timely basis. By disposing of such interests, the CPAs avoid a challenge to their independence in dealing with the new client. To illustrate, assume that a senior auditor who owns shares of common stock in a prospective client (a direct financial interest) is going to be placed on the engagement team. That individual's independence is impaired because of the financial interest and, if placed on the engagement team, the firm's independence also would be impaired. Therefore, the individual must dispose of the financial interest before beginning work on the engagement.

Material indirect investments by covered members are also prohibited. An investment in a mutual fund may serve to illustrate the difference between the effects of direct and indirect financial interest. Assume that a CPA invests in a diversified mutual fund (for our purposes, one that holds investments in a wide variety of securities). The mutual fund Jano Diversified Mutual Fund (Jano) owns stock of Apple Inc. If the CPA firm audits Jano itself, any staff or partner investments in that fund are considered direct financial interests and are not allowed for covered members (e.g., members of the Jano audit team).

Alternatively, if the CPA firm audits Apple, the investment by the covered member in Jano represents an indirect financial interest. A covered member on the Apple audit may hold an investment in Jano if the investment is not material. The **Illustrative Case: Indirect Financial Interests** provides details about this situation.



Illustrative Case

Indirect Financial Interests

A covered member who owns shares in a mutual fund has a direct financial interest in the

mutual fund, and an indirect financial interest in the mutual fund's investments. Thus, a covered member could not be involved in the audit of the mutual fund itself due to the direct financial interest. Concerning the mutual fund's investments in companies potentially audited by the covered member's firm, the following apply:

1. Ownership of 5% or less of the outstanding shares of a *diversified* mutual fund by the covered member: the investment would be considered an immaterial indirect financial interest in the companies that the mutual fund holds.
2. Ownership of more than 5% of outstanding shares of a *diversified* mutual fund by the covered member: the covered member should evaluate the mutual fund's underlying investments to determine whether the covered member holds a material indirect financial interest.

The following illustrates how to evaluate whether the underlying investment is material to a *covered member's* net worth. Assume:

- Jano Mutual Fund, a diversified fund, has net assets of \$10 million, composed of an investment in shares of client Apple and a variety of other investments.
- The *covered member* owns 6 percent of the outstanding shares of Jano Mutual Fund (a value of \$600,000).
- Jano Mutual Fund has 2 percent of its assets invested in Apple (a \$200,000 investment).

In this situation, the *covered member's indirect financial interest* in Apple is \$12,000 (\$600,000 × 2%). The *covered member* would then compare the \$12,000 *indirect financial interest* with their net worth, including the net worth of their *immediate family*, to determine whether the *indirect financial interest* in Apple Inc. is material. [adapted, *Code of Professional Conduct* 1.240.03]

If the mutual fund is "nondiversified," the above evaluation should be performed regardless of the member's percentage of ownership in the fund.

Loans to or from an attest client, officer, or any individual owning 10 percent or more of the attest client's equity also present an independence problem for a covered member. In general, because these are direct financial interests, a covered member *may not have such loans*.⁸ Also, any **joint closely held investment** with these individuals must be immaterial to the covered member.

The independence rules are somewhat complex. To help you get a good understanding of the nature of the rules, Figure 3.9 summarizes a number of relationships held by firm members and describes their effect on the independence of the CPA firm.

Effects of Interests of a Covered Member's Relatives and Friends on Independence How is independence affected by a financial interest or business position held by a relative of a covered member? The answer depends on the *closeness* of the family relationship and on whether the CPA works in the engagement office. The *Code examines closeness of relationship by using the categories of* (1) immediate family, (2) close relatives, and (3) other relatives and friends.

Immediate Family Interests The Independence Rule generally treats the interests of CPAs and their immediate families as indistinguishable from each other. Thus, as a general rule, a covered member's **immediate family members** (spouse, spousal equivalent, or dependents) are subject to the same independence requirements as the covered member. Accordingly, for example, if a covered member's spouse owns even one share of a client's stock, the situation is evaluated as if the covered member held the stock and independence is impaired. A public accounting firm may retain its independence with respect to the engagement only by making certain that the CPA is not a covered member for that particular client.

⁸ Certain exceptions to this requirement are included for financial institution clients (*Code of Professional Conduct* 1.260.020), including (1) automobile loans and leases collateralized by the automobile, (2) loans of the surrender value under the terms of an insurance policy, (3) loans fully collateralized by cash deposits at the same financial institution, and (4) aggregated outstanding balances from credit cards and overdraft reserve accounts that have a balance of \$10,000 or less.

FIGURE 3.9 Effects of CPA Relationships on Firm Independence

	Covered Member	Not a Covered Member
1. A CPA partner, employee, or an investment club of such partners and employees owns more than 5% of client's outstanding equity securities or other ownership interests.	Firm independence impaired	Firm independence impaired
2. A CPA firm partner or employee is simultaneously associated with client as director, officer, employee, promoter, trustee, etc.	Firm independence impaired	Firm independence impaired
3. A CPA has any direct or a material indirect financial interest in the attest client.	Firm independence impaired	Firm independence not impaired (direct interest must be less than 5%, as indicated in 1 above)
4. A CPA has a material joint closely held investment with the client (or client's officers, directors, etc.)	Firm independence impaired	Firm independence not impaired

There are two exceptions to the general rule that the interests of CPAs and their immediate families are considered indistinguishable from one another. First, an immediate family member may be employed with the attest client if the family member is not employed in a **key position**. A key position is one that includes primary responsibility for, or influence over, the contents of the financial statements. Examples of key positions include member of the board, chief executive officer, president, chief financial officer, chief operating officer, general counsel, controller, and treasurer. The second exception allows the family member, but only under very specific circumstances, to participate in an employer benefit program, to receive share-based compensation, and to participate in certain deferred compensation plans.

An effective approach for considering an immediate family member's financial or business interest is to first assume it is that of the CPA. If the CPA's independence is impaired under that assumption, the CPA is not independent unless one of the two exceptions in the preceding paragraph applies.

Close Relatives Interests Independence may also be impaired by financial interests or business relationships of close relatives (e.g., parents, siblings, or nondependent children). The independence standard for **close relatives** applies to (1) members of the attest engagement team, (2) individuals in a position to influence the attest engagement, and (3) any partner in the engagement office. For these three groups, public accounting firm independence is impaired if a close relative has

- A key position with the client, or
- A financial investment in the client that
 - Is material to the close relative's net worth and *of which the accountant has knowledge*; or
 - Enables the close relative to exercise **significant influence** over the client.

Other Considerations for All Relatives and Friends The ethics standards do not attempt to enumerate every circumstance in which the appearance of independence might be questioned. In considering whether other relationships might impact independence, a CPA should consider whether the personal or business relationships would lead a reasonable person, aware of all the relevant factors, to conclude that there is an unacceptable threat to independence. This evaluation (at both the accountant and the firm levels) is made using the AICPA *Conceptual Framework for Independence*.



Illustrative Case

Employment with Clients

The situation in which audit clients hire audit firm personnel is difficult. On the one hand, it

provides great professional opportunities for individuals who enter the public accounting profession. On the other, independence concerns have led to the restrictions presented in this section.

Questions were raised about the number of ex-Arthur Andersen employees hired by Enron Corporation prior to its collapse (see Chapter 1). Although both firms refused to disclose details, the positions and numbers of ex-Arthur Andersen employees hired by Enron seem significant. *The Wall Street Journal* reported that Enron executives who had previously worked with Arthur Andersen in auditing included its chief accounting officer, its chief financial officer, and the vice president of corporate development. The *Washington*

Post indicated that, over the years Arthur Andersen served as auditor, 86 employees left the firm and accepted positions at Enron.

In addition, questions arose as to the nature of the relationship between continuing Arthur Andersen employees and those of Enron. Again, *The Wall Street Journal* reported that Arthur Andersen auditors and consultants “shared in office birthdays, frequented lunch-time parties in a nearby park and participated in weekend fundraisers for charities. They even went on Enron employees’ ski trips to Beaver Creek, Colorado.” One Enron employee suggested that “people just thought they were Enron employees . . . they walked and talked the same way.” Consistently, the *Washington Post* reported that the chief accounting officer was the Arthur Andersen partner’s “regular golfing buddy” and that people at Enron referred to Andersen as “Enron Prep.”

Figure 3.10 provides a brief summary of the complex independence requirements that apply to a CPA’s relatives. Professional employees with potential problems should consult their firm’s policies, as well as the *Code* section on Family Relationships with Attest Clients.

Future Employment with a Client

Another relationship that may affect independence is when a covered member is offered or seeks employment with an audit client. Accordingly, covered members should report to the public accounting firm any specific offer or the intention to seek employment with

FIGURE 3.10 Effect on Independence of Family Members, Relatives, and Friends*

Relative	Effect on Accountant and Firm Independence
Immediate Family (spouse, spousal equivalent, or dependent)	General Rule: A covered member’s immediate family members must, in general, comply with the Independence Rule. Accordingly, when an immediate family member violates the Independence Rule or one of its interpretations, independence of the covered member and the firm is impaired. Exceptions to the General Rule: The accountant and firm are independent 1. When a family member is employed by a client in other than a key position. 2. In certain circumstances in which the immediate family member participates in a benefit plan related to a client.
Close Relatives (parent, sibling, or nondependent child)	Accountant and firm independence are impaired if an individual on the audit team, an individual in a position to influence the attest engagement, or any partner in the engagement office has a close relative who has 1. A key position with the client or 2. A material financial interest of which the accountant has knowledge.
Other Relatives and Friends	Independence is only impaired when a reasonable person, aware of all relevant facts relating to a situation, would conclude that there is an unacceptable threat to independence; this evaluation (at both the accountant and the firm levels) is made based on the AICPA <i>Conceptual Framework</i>.

*Summary omits consideration of certain detailed factors that may affect independence. Consult independence rule and its interpretations for a detailed consideration of the effect on independence of family members and relatives.

an audit client. After such communication, the public accounting firm should remove that CPA from all engagements for that client until the offer has been rejected or employment is no longer being sought. The firm should also consider whether additional procedures are necessary to provide reasonable assurance that all work of that CPA was performed with objectivity and integrity.

When a public accounting firm professional accepts employment with the audit client, the engagement team should consider the need to modify future engagement procedures to adjust for the risk that audit effectiveness could be reduced due to the professional's knowledge of the audit plan. When the professional will have significant interaction with the engagement team, the firm should assess whether the existing team members have the appropriate experience and status to deal effectively with the former firm professional. Particular care should be taken in reviewing the audit when the former firm professional joins an attest client in a key position.

For auditors of public companies, the restrictions regarding employment with an audit client are more stringent. The Sarbanes–Oxley Act of 2002 requires that one year pass before a member of the audit team may accept employment with an SEC registrant in certain designated positions (e.g., chief executive officer, controller, chief financial or accounting officer).

Gifts and Entertainment

An outsider may question the independence of a public accounting firm in a situation in which a covered member receives an expensive gift from a client or gives an expensive gift to a client. Any gifts accepted from a client by a covered member must be clearly insignificant in value to the recipient. Consistently, accepting payments for entertainment by an attest client must be reasonable in the circumstances. Similar restrictions exist for offering gifts to an attest client.

Overall Firm Independence Requirements

In preceding sections we have presented a number of situations in which impaired independence of individual CPA firm staff and partners may impair independence of the firm. Here we present a number of circumstances relating directly to the CPA firm that may impair firm independence.

Professional Fees Considerations

Unpaid fees as well as the total level of overall fees from a client may affect independence. Unpaid fees owed to a covered member (e.g., the firm itself is a covered member) by a client may create a threat to CPA independence as questions may arise as to whether the CPA firm's prospects for collection depend upon the nature of the CPAs' report on the current financial statements. The *Code* suggests that

- Threats to independence are at an acceptable level when unpaid fees are clearly insignificant and relate to professional services provided less than one year prior to the issuance date of the current report.
- Threats are *not* at an acceptable level when unpaid fees are at a significant level and relate to professional services provided more than one year prior to the issuance date of the current report.
- Other situations may require judgment as to whether they should be considered threats to independence depending upon the facts involved.

When threats to independence are not at an acceptable level, the CPAs should follow the conceptual framework for independence (presented earlier) and apply safeguards to eliminate the threats or reduce them to an acceptable level to safeguard independence (e.g., obtain partial payment that makes the unpaid balance insignificant, or obtain agreement with the client to a payment schedule that the auditor believes the client has the ability to pay prior to issuance of the report). In the extreme, the auditor may need to suspend further work on the current engagement and not accept new engagements with the client.

Various situations and actions related to audit fees are discussed in detail in AICPA ET 1.230. This is an area in which the PCAOB requirement differs somewhat as independence is impaired if fees for *any* professional services rendered more than one year prior to the audit report date for the current year's audit have not been collected before issuance of the CPAs' report (PCAOB ET 191).

The total level of fees to a client, whether paid or unpaid, compared to the firm's total fees also raises independence issues. As indicated in Figure 3.8, when the total fees generated from an attest client represent a large proportion of the total fees of the firm or a covered member (e.g., when a partner's salary is in part based on their total fees collected), their level may create a self-interest threat to independence. Possible safeguards include limiting other services performed for the client and expanding the overall client base. In the extreme, when withdrawal from the engagement is not considered necessary, a possible safeguard when the situation is persistent annually with a client is to engage an appropriate reviewer who is not a member of the firm to review the engagement.⁹

As a final matter, the audit fee should not be affected by the existence or nonexistence of other services performed by the CPA firm for the client. An exception applies to situations in which cost savings are achieved due to previous provision of other services to the client.

Litigation

Litigation involving the public accounting firm and the client also may affect the independence of CPAs. The relationship between the CPAs and client management must be characterized by complete candor and full disclosure. A relationship with these characteristics may not exist when litigation places the CPAs and client management in an adversarial position. CPAs in litigation, or potential litigation, with a client must evaluate the situation to determine whether the significance of the litigation affects the client's confidence in the CPAs or the CPAs' objectivity.

Providing Nonattest Services

An ethical issue that has been at the forefront of the profession in recent years is the possible threat to the CPAs' independence when they perform attest services and nonattest services for the same client. What restrictions exist on providing nonattest services for a client?

An interpretation of the AICPA's independence rules states that while the CPAs should not perform management functions or make management decisions for the attest client, they may provide advice, research materials, and recommendations to assist the client. In such circumstances, the client must agree to

- Assume all management responsibilities.
- Oversee the service, by designating an individual, preferably within senior management, who possesses suitable skill, knowledge, and/or experience.
- Evaluate the adequacy and results of the services performed.
- Accept responsibility for the results of the services.
- Establish and maintain internal control, including monitoring ongoing activities.

In addition to the *Code*, the AICPA's Management Consulting Services Executive Committee issues *Statements on Standards for Consulting Services* with guidance on providing consulting services to attest and nonattest clients. Before performing nonattest services, the CPAs should establish and document in writing the understanding with the client, including objectives of the engagement, services to be performed, the client's acceptance of its responsibilities, the CPAs' responsibilities, and any limitations of the engagement.

⁹ The International Ethics Standards Board for Accountants includes a 30% threshold over the past five years for requiring such a review, while AICPA and PCAOB standards allow members to use professional judgment to determine when specific facts and circumstances over such a time period create such threats.

Given these rules, there are certain activities that CPA firm personnel cannot perform for the firm to retain independence with respect to the client. Examples of these prohibited activities include

- Setting policy or strategic direction for the client.
- Directing or accepting responsibility for the actions of the client's employees, except as allowable for using internal auditors to provide assistance.
- Authorizing, executing, or consummating a transaction.
- Preparing source documents (e.g., purchase orders, payroll time records, and customer orders).
- Having custody of client assets.
- Supervising client employees in their normal recurring activities.
- Performing ongoing evaluations of the client's internal control as a part of its monitoring activities.

Despite the above guidance, questions arise as to how much assistance CPAs may provide relating to information systems without impairing independence. For example, may a CPA assist a client in implementing a new or existing accounting standard or in designing and installing an information system?

The *Code* indicates that, absent other factors, a CPA's independence is not impaired when that CPA assists a client with implementing a new or existing accounting standard when the CPA does not perform any managerial responsibilities and the attest client's individual overseeing the service is capable of making all significant judgments and decisions related to the standard (ET 1.295.113).

Concerning the design and installation of an information system, the *Code* outlines services that do not impair independence and those that do. Services that do not impair independence:

- Relate to a system other than the financial information system (e.g., certain information systems used only for controlling efficiency and effectiveness of operations).
- Relate to implementation (using vendor-available settings) of commercial **off-the-shelf** financial information system software where the service does not include activities such as those listed in the following bullets.

Services that impair independence:

- Relate to modification of commercial off-the-shelf financial information system software (e.g., design, development, customizations, the building of interfaces, or the creation of data translation programs).
- Relate to a financial information system the CPA designs or develops.

The standard (ET 1.295.145) includes detailed definitions and requirements that are needed to resolve any particular set of circumstances.

The ethics standards make it clear that the firm of a CPA who becomes a part-time controller for a client and assumes a *decision-making role* in the client's affairs is not in a position to make an independent audit of the financial statements. However, the firm of a CPA who provides bookkeeping or accounting services for the client can maintain independence under the AICPA rules. As long as the client takes responsibility for the financial statements and the auditors perform their engagement in accordance with generally accepted auditing standards, independence is not considered impaired. Of course, the accounting services provided cannot include executing transactions or performing other management functions. As we will describe in the next section, the rules for auditors of public companies prohibit them from performing any accounting or bookkeeping services for the client, along with a host of other services.

The AICPA maintains that public accounting firms have long been rendering consulting services to management while continuing to perform audits in an independent manner that serves the public interest. The AICPA and leaders of a number of public accounting

firms have argued that the additional knowledge of the client that comes from performing these services actually enhances the audit. It also allows public accounting firms to have associates with more expertise, especially in the area of information technology. However, this is not the view of many critics of the profession, including some individuals from the Securities and Exchange Commission (SEC) and Congress. These concerns led to the provisions of the Sarbanes–Oxley Act of 2002 that prohibit the performance of a wide range of nonattest services for public company audit clients.

Independence—Requirements for Audits of Public Companies

LO 3-6

Contrast the independence rules for audits of public companies with those for audits of nonpublic companies.

Independence standards for public companies are currently a combination of pronouncements by the AICPA, the SEC, and the legal requirements of the Sarbanes–Oxley Act of 2002, as enforced and interpreted by the PCAOB. Historically, the AICPA has issued, and continues to issue, independence requirements that apply to its members. The SEC also has established independence requirements for audits of public companies that supplement those of the AICPA.

Since passage of the Sarbanes–Oxley Act of 2002, the PCAOB has been responsible for adopting or establishing the ethical and independence standards for audits of public companies, with the authority and oversight of the SEC. But since public companies are governed by both SEC and PCAOB standards, a question arises as to their relative authority when their existing standards differ. The PCAOB standards resolve this by stating that when a provision of the SEC’s independence requirements is more restrictive—or less restrictive—than that of the PCAOB, the accounting firm must comply with the more restrictive rule (PCAOB Rules 3500T and 3520).

The Sarbanes–Oxley Act of 2002 makes it unlawful for a registered public accounting firm that audits a public company to provide a variety of nonattest services to that client. Figure 3.11 summarizes those services as well as the AICPA’s guidance. Bear in mind that the AICPA’s guidance is relevant for nonpublic clients only. In addition, CPAs generally may provide allowed nonattest services only if they are approved in advance by the audit committee of the client’s board of directors. Also, clients must disclose in their annual report fees paid for (1) audit services, (2) audit-related services, (3) tax services, and (4) other services.

Providing Tax Services

What is the responsibility of the CPA firm in providing a client with tax services? The firm and its personnel have a primary responsibility to the client: that is, to see that the client pays the proper amount of tax and no more. In the role of tax advisor, the certified public accountant may properly resolve questionable issues in favor of the client, and the CPA is not obliged to maintain the posture of independence required in attestation work.

A second responsibility of CPAs on tax engagements is to the public, whose interests are represented by the government—more specifically, by the Internal Revenue Service (IRS). To meet this responsibility, CPAs must observe the preparer’s declaration on the tax returns they prepare. The declaration requires the preparer to state that the return is “true, correct, and complete . . . based on all information of which the preparer has any knowledge.” To comply with this declaration, what steps must the public accounting firm take to acquire knowledge relating to the tax return? The firm is not required to perform an audit; knowledge of the return may be limited to information supplied to the firm by the client. However, if this information appears unreasonable or contradictory, the CPAs are obligated to make sufficient investigation to consider these issues. Information that appears plausible to a layperson might appear unreasonable to CPAs because they are experts in evaluating financial data. CPAs are not obligated to investigate any and all information provided by the taxpayer, but they cannot ignore clues that cast doubt on the accuracy of these data.

In addition to being guided by the declaration on the tax return, CPAs should look to a series of pronouncements issued by the AICPA’s Tax Executive Committee, entitled *Statements on Standards for Tax Services*. These statements address such questions as: Under what circumstances should a CPA sign the preparer’s declaration on a tax return?

FIGURE 3.11 Comparison of Sarbanes–Oxley and AICPA Requirements Regarding Providing Nonattest Services to Audit Clients

Service Not Allowed by Sarbanes–Oxley	AICPA Code of Professional Conduct Requirements
Bookkeeping or other services related to the accounting records or financial statements	Allowed, providing the auditors <i>do not</i> - Determine or change journal entries without client approval. - Authorize or approve transactions. - Prepare source documents. - Make changes to source documents without client approval.
Financial information systems design and implementation	Auditors are allowed to - Implement a system not developed by the auditor (e.g., off-the-shelf accounting packages). - Assist in setting up a chart of accounts and financial statement format. - Design, develop, install, or integrate an information system unrelated to the financial statements or accounting records. - Provide training to client employees on the information and control system.
Appraisal, valuation, and actuarial services	Allowed, providing services <i>do not</i> - Relate to a material portion of the financial statements <i>and</i> - Involve a significant degree of subjectivity.
Internal audit outsourcing services	Allowed, providing the client accepts its responsibility for internal control and - Designates competent individual(s) within the company to be responsible for the internal audit. - Determines scope, risk, and frequency of internal audit activities. - Evaluates findings and results. - Evaluates adequacy of audit procedures performed.
Management functions or human resources	Auditors may provide various types of advice but may not perform management functions.
Various investment services	Certain services are allowed, including - Assisting in developing corporate finance strategies. - Recommending allocation of funds to investments.
Legal services and expert services unrelated to auditing	Legal services are not directly addressed; various other services are allowed if auditors do not make management decisions.
Certain tax services, such as tax planning for potentially abusive tax transactions and providing individual tax services to client officers who play a significant role in financial reporting	No specific restrictions.

What is the CPA's responsibility for errors in previously filed returns? Should CPAs disclose the taking of positions that differ from IRS interpretations of the tax code?

Independence Requirements of Government Auditing Standards

The Government Accountability Office (GAO) develops additional requirements for audits of entities that receive federal financial assistance. These requirements are included in *Government Auditing Standards*, which are discussed in Chapter 21. With regard to auditor independence, *Government Auditing Standards* also are more restrictive than those of the AICPA. As an example, a public accounting firm cannot allow personnel working on nonattest engagements to also work on the audit. In addition, *Government Auditing Standards* place restrictions on the nature of the nonattest services that may be provided to an audit client. Nonattest services must be deemed not to be significant or material to the subject matter of the audit. Under the GAO's interpretation of this requirement, restrictions are placed on the nature of bookkeeping, payroll, valuation, information technology, human resources, and internal audit services.

	Illustrative Case	Nonattest Services
	In the period between 2000 and 2002, three of the Big 4 CPA firms sold their consulting divisions as follows: • Ernst & Young to CapGemini • PricewaterhouseCoopers to IBM • KPMG through an IPO became BearingPoint In addition, Deloitte tried to sell its consulting division but failed and decided to retain it. The sales were a reaction to the Sarbanes–Oxley Act, which restricted the scope of nonaudit services that could be offered to audit clients. The Act was passed after a number of highly publicized cases were highlighted by the SEC and Congress as	

examples of situations in which performing nonattest services for a client may have affected auditor independence. As an example, Global Crossing Ltd. reported it paid Arthur Andersen \$2.3 million in audit fees in 2000, but also paid more than \$12 million in fees for nonattest services.

Recently, a high demand for consulting services has resulted in the CPA firms again becoming involved in consulting. For example, in 2014, PricewaterhouseCoopers purchased the consulting firm Booz & Co. to enhance its consulting practice. The firms have realized that the Sarbanes–Oxley Act regulations could be met if they built a practice that largely consisted of nonaudit clients where conflict situations do not arise; and for audit clients, they simply avoid selling certain services. In 2014, James Doty, chair of the PCAOB, provided his view of the situation when he stated, “This is a problem that won’t go away.”

	Illustrative Case	Tax Services and Independence
	The issue of independence and tax services was vividly illustrated in the Sprint Corp. case. Sprint had a policy of allowing its audit firm, Ernst & Young LLP, to perform tax planning services for its top executives. The chief executive officer and the president of Sprint adopted a tax shelter strategy recommended by Ernst & Young. When the shelter	

was determined to be ineffective, the executives were faced with potential liabilities of millions of dollars in back taxes, which created a conflict of interest between them and Ernst & Young. Rather than discharge the auditors, the board of directors of Sprint elected to force out the two executives. The Sprint case and similar cases resulted in the PCAOB standards restricting the performance of tax services for the executives of audit clients.

Independence—Reality

It is certainly naive to believe that all CPAs are able to maintain complete independence when performing attest services in an environment in which they work closely with client management and are paid fees by their clients. Yet, as we have emphasized, independence and the application of professional skepticism are essential to performance of the attest function. While performing attest services, it is essential that CPAs bear in mind that investors, creditors, and other stakeholders rely upon the reliability of the information.

Various regulations by the SEC and stock exchanges have served to increase the CPAs’ independence in dealings with management and to improve the quality of financial reporting by public companies. The New York Stock Exchange, the American Stock Exchange, and Nasdaq all require independent **audit committees** by all listed companies. According to these requirements, audit committees must consist of at least three independent nonmanagement financially literate individuals, and the chair must have accounting or financial management expertise. In addition, the Sarbanes–Oxley Act of 2002 makes the audit committee directly responsible for appointing, compensating, and overseeing the public accounting firm. The SEC regulations require public companies to file a copy of the audit committee’s charter every three years and disclose whether its members are independent of management.

Independence Requirement Violations

As we have stressed, auditor independence is basic to audits and other attest services. Yet, the many detailed independence requirements, combined with the numerous partners and employees involved with such engagements creates a significant risk of violation of independence rules on any specific audit or attest engagement. Accordingly, the AICPA ethical standards (ET 1.298) require the CPA firm to promptly communicate a breach to the appropriate firm personnel, such as the individual in charge of policies and procedures related to independence or the partner in charge of the particular engagement. Then the firm should ensure that appropriate action is taken (1) to determine that the interest or relationship that caused the breach no longer exists and (2) to evaluate the significance of the breach on the engagement team's integrity, objectivity, and professional skepticism and its ability to issue the report. ET 1.298 provides detailed guidance for evaluating both the significance and the consequences of a breach. Ultimately, possible actions by the firm range from removing the individual with the independence issue from the engagement team to resigning from the engagement.

Both the SEC and the PCAOB provide additional guidance for public companies. SEC requirements (17 C.F.R. § 210.2-01, *Qualifications of Accountants*) indicate that auditors will *not* be determined to have violated the independence requirements for an "inadvertent" violation if (1) when it occurred the covered person did not know of the circumstances giving rise to a lack of independence (e.g., it related to a relative's actions), (2) the covered person's lack of independence was corrected promptly, and (3) the accounting firm has a quality management system in place that provides reasonable assurance that the firm and its employees do not lack independence.

The PCAOB's approach (*Staff Guidance: Rule 3526(b) Communications with Audit Committees Concerning Independence*) differs somewhat from that of the SEC. If a breach is identified, the CPA firm must address the underlying circumstances that resulted in the violation and determine that (1) the violation was of such a nature that the firm was capable of exercising objective and impartial judgment as it related to all issues within the audit and (2) a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the firm was capable of exercising such objective and impartial judgment. In addition, the matter must be communicated to the client's audit committee, which will make similar judgments.

The major risk of a decision to continue an audit engagement when a breach of independence has occurred is that the audit may be deemed deficient by the SEC. If this occurs, the client will be required to engage another CPA to reperform the audit.

Additional Code of Professional Conduct Rules

LO 3-7

Describe additional Code of Professional Conduct rules.

Integrity and Objectivity Rule

Recall from Figure 3.4 that in addition to the Independence Rule, the *Code* consists of a variety of additional rules. In the following sections, we discuss each of those.

Integrity and Objectivity Rule: In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.

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The Integrity and Objectivity Rule applies to all members of the AICPA and all services provided by CPAs. It recognizes that clients, employers, or others may at times attempt to influence the judgment of CPAs on professional matters. To maintain the confidence and respect of the public, CPAs must never subordinate their professional judgments to those of others. An interpretation of the rule states that CPAs will be found to have knowingly misrepresented facts in violation of the Integrity and Objectivity Rule when they knowingly



Illustrative Case

A Lack of Integrity: Inappropriately Obtaining Information on Upcoming Inspections

CPA firms periodically find that some partner and employee behavior doesn't meet the firm's standards. During 2015–2017 a number of partners within a large CPA firm received advanced information on which audits the PCAOB intended to inspect (Chapter 2 presents information on firm inspections). Most directly involved were three high-level national CPA firm partners and three PCAOB employees, two of whom were hired by the CPA firm during the process. The PCAOB employees had knowledge of the future inspections and passed it on to the CPA firm partners, who then

directed others to “re-review” the various audits for possible PCAOB violations that might arise in an inspection. The scheme was revealed by a CPA firm partner who learned that one of her audits was on the inspection list. She reported the matter to her supervisor and ultimately the firm reported the situation to the PCAOB.

The individuals involved in the case faced a number of ethical and legal issues. CPA ethical penalties include AICPA expulsion and CPA certificate revocation. Legally, criminal convictions have occurred. None of these six individuals now works with either the CPA firm or the PCAOB.

- Make, permit, or direct another to make materially incorrect entries in a client's financial statements or records.
- Fail to correct financial statements that are materially false or misleading when the member has such authority.
- Sign, or permit or direct another to sign, a document containing materially false and misleading information.

It is often difficult to determine if an individual has “knowingly misrepresented facts.” Thus, in evaluating whether a CPA has violated the Integrity and Objectivity Rule, we must look to whether, based on the circumstances, the CPA *should have* known of the misrepresentation. A ruling that a CPA violated the rule is most commonly based upon evidence that the CPAs should have been knowledgeable about the facts.

CPAs must also be particularly careful relating to the performance of nonattest services, such as tax and consulting services, that involve the CPA acting as an advocate for the client (e.g., on certain tax matters). The Integrity and Objectivity Rule is clear: The CPA must not misrepresent facts or subordinate judgment.

General Standards Rule

General Standards Rule: A member shall comply with the following standards and with any interpretations thereof by bodies designated by Council.

- Professional Competence. Undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence.
- Due Professional Care. Exercise due professional care in the performance of professional services.
- Planning and Supervision. Adequately plan and supervise the performance of professional services.
- Sufficient Relevant Data. Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

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In addition to performing audits and other attestation services, CPAs also provide accounting, review, tax, and consulting services. Clients and the general public expect these services to be performed with competence and professional care. Therefore, the General Standards Rule applies to *all CPA services*. Figure 3.12 provides technical bodies authorized under this rule and the following two rules as indicated in the third column.

FIGURE 3.12 Technical Bodies and Their Authority

Technical Body	Primary Authority	Rule(s)
AICPA's Accounting and Review Services Committee	Compilations, reviews, and attestation standards for services related to unaudited information of nonpublic companies.	
AICPA's Auditing Standards Board	Auditing standards for engagements not covered by the standards of the PCAOB and attestation standards.	General Standards
AICPA's Forensic and Valuation Services Executive Committee	Forensic and valuation services standards.	Compliance with Standards
AICPA's Management Consulting Services Executive Committee	Management consulting and attestation standards.	
AICPA's Personal Financial Planning Section	Personal financial planning services standards.	
AICPA's Tax Executive Committee	Tax services standards.	
Federal Accounting Standards Advisory Board	Accounting standards for federal governmental entities.	Accounting Principles
Financial Accounting Standards Board	Accounting standards for nongovernmental entities.	Accounting Principles
Governmental Accounting Standards Board	Accounting standards for state and local governmental entities.	Compliance with Standards Accounting Principles
International Accounting Standards Board	International financial accounting and reporting principles.	Compliance with Standards Accounting Principles
Public Company Accounting Oversight Board	Auditing and related attestation standards, quality control independence ethic, and other standards for public (issuer) companies.	General Standards Compliance with Standards

Compliance with Standards Rule

Compliance with Standards Rule: A member who performs auditing, review, compilation, management consulting, tax, or other professional services shall comply with standards promulgated by bodies designated by Council.

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The Compliance with Standards Rule requires CPAs to adhere to professional standards issued by various technical bodies (see Figure 3.12). CPAs must become familiar with such statements and apply them to their engagements. To violate standards prescribed by these bodies is to violate the Compliance with Standards Rule of the *Code*.

Accounting Principles Rule

Accounting Principles Rule: A member shall not (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles that has a material effect on the statements or data taken as a whole. If, however, the statements or data contain such a departure and the member can demonstrate that due to unusual circumstances the financial statements or data would otherwise have been misleading, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

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The Accounting Principles Rule recognizes the authority of certain designated bodies to issue generally accepted accounting principles. Under this rule, as indicated in Figure 3.12, the AICPA has designated the Financial Accounting Standards Board (FASB), the Governmental Accounting Standards Board (GASB), the Federal Accounting Standards Advisory Board (FASAB), and the International Accounting Standards Board (IASB) as such bodies. In addition, a CPA may report on financial statements prepared following principles of other organizations (e.g., a particular country, a contract, or a legal statute) if the CPA's report or the financial statements make clear the financial reporting framework used and do not suggest that generally accepted accounting principles were used.

Acts Discreditable Rule

Acts Discreditable Rule: A member shall not commit an act discreditable to the profession.

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The Acts Discreditable Rule gives the AICPA the authority to discipline those members who act in a manner damaging to the reputation of the profession. The three



Illustrative Case

Acts Discreditable to the Profession

The Code of Professional Conduct has long required that members retain integrity and not commit acts discreditable to the profession. In 2022, the Securities and Exchange Commission charged a large multinational CPA firm with withholding information on cheating by many of its audit professionals on exams.

The related SEC administrative proceeding reports that over multiple years, many audit professionals cheated on ethics exams and on a wide variety of continuing professional education course exams (e.g., received and used answer keys from colleagues). Also, at one point, a flaw in the CPA firm's software allowed professionals to pass CPE exams without the required number of correct responses.

Many professionals indicated that such cheating was due to work commitments or an inability to pass training exams after multiple attempts. Indeed, numerous audit professionals

cheated after the firm's managing partner had sent a message emphasizing the importance of integrity and reminding personnel to avoid such behavior.

As graduates begin their professional career, it is extremely important to understand the consequences of making inappropriate decisions or taking shortcuts that can significantly impact their career. Indeed, to many, matters such as the above are clearly discreditable acts that show a lack of integrity. Nonetheless, in 2023, the AICPA added to its *Code of Professional Conduct* the prohibition of such cheating relating to CPE courses.

Ultimately, the firm was fined \$100,000,000 and required to engage in various undertakings, including retaining two separate independent consultants to help remediate its deficiencies. Previously, another large multinational CPA firm was assessed a fine of \$50,000,000 for professionals cheating on internal training exams, as well as the firm receiving stolen information about forthcoming PCAOB inspections.

bulleted circumstances outlined in our discussion of the Integrity and Objectivity Rule relating to misleading entries and financial statements are considered discreditable. Other examples are

- Soliciting or knowingly disclosing Uniform CPA exam questions or answers.
- Soliciting or knowingly disclosing continuing professional education questions or answers.
- Failure to comply with applicable federal, state, or local laws or regulations regarding the filing of tax returns.
- Unauthorized disclosure of confidential client information.

Is it discreditable to refuse to return records relating to a client's accounting system and the audit? The answer depends upon the facts and circumstances and the records involved. The following summarizes the CPA's responsibility:

Type of Information	CPA Responsibility
Records provided by the client.	Return to client at the client's request.
CPA-prepared records that the CPA was not specifically engaged to prepare and are not in the client's books and records, with the result that the client's financial information is incomplete (e.g., adjusting entries, closing entries, and supporting schedules prepared as part of an engagement).	Provide to client unless being withheld because of fees that are due to the CPA for the related work product.
CPA work products (e.g., "deliverables" such as audit report, tax returns).	Provide to client unless work product is being withheld because • There are fees due on that work product. • Work product is incomplete. • Withholding of work product is required to comply with a professional standard (e.g., withholding an audit report due to outstanding audit issues). • There is threatened or outstanding litigation concerning the engagement or CPA's work.
CPA working papers prepared solely for the engagement either by the auditor (e.g., audit programs, analytical review procedures schedules) or by the client (at the request of CPA).	Need not be provided.

You should also understand that if an authoritative regulatory body such as the CPA's state board of accountancy has a more strict rule, the CPA must follow it. Finally, when a CPA complies with the above rules, that CPA is under no ethical obligation to comply with subsequent requests for such documents unless extraordinary circumstances are involved (e.g., a natural disaster or an act of war that destroyed the client's copies of the records).

Contingent Fees Rule

Contingent Fees Rule: A member in public practice shall not:

1. Perform for a contingent fee any professional services for, or receive such a fee from a client for whom the member or the member's firm performs:
 - a. An audit or review of a financial statement; or
 - b. A compilation of a financial statement when the member expects, or reasonably might expect, that a third party will use the financial statement and the member's compilation report does not disclose a lack of independence; or
 - c. An examination of prospective financial information; or

2. Prepare an original or amended tax return or claim for a tax refund for a contingent fee for any client.

The prohibition in (1) above applies during the period in which the member or the member's firm is engaged to perform any of the services listed above and the period covered by any historical financial statements involved in any such listed services.

Except as stated in the next sentence, a contingent fee is a fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service. Solely for purposes of this rule, fees are not regarded as being contingent if fixed by courts or other public authorities, or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies.

A member's fees may vary depending, for example, on the complexity of services rendered.

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An accountant in public practice is prohibited by the Contingent Fees Rule from providing services on a contingent fee basis in certain circumstances. No contingent fee engagements are allowed for services performed for a client that also engages that public accounting firm to perform audits, reviews, certain compilations of financial statements, or examinations of **prospective financial information**. For example, consulting services may not be performed for a contingent fee for an audit client of the public accounting firm.

The CPAs may perform services for contingent fees for other clients. Consider a public accounting firm with a prospective new client whose management requests assistance in redesigning its cash disbursements system. In such circumstances, if none of the services described in part 1 of the rule are provided for that client, the CPAs may perform the service for a contingent fee. For example, the CPAs may redesign the disbursements system and receive a fee that is contingent on the amount of cost savings realized by the client in processing future cash disbursements. The CPAs' fee might be, for example, 25 percent of the next four years' cost savings.

The area of taxation has additional restrictions. A CPA may not receive a contingent fee for the preparation of original or amended tax returns or claims for tax refunds. Preparation of a tax return includes giving advice on how particular items should be handled on the return.

The PCAOB rules contain an additional restriction with respect to contingent fees. The auditors of public companies are prohibited from accepting engagements for tax services that are determined based on the results of judicial proceedings or the findings of government agencies.

Commissions and Referral Fees Rule

Commissions and Referral Fees Rule:

1. Prohibited commissions. A member in public practice shall not for a commission recommend or refer to a client any product or service, or for a commission recommend or refer any product or service to be supplied by a client, or receive a commission, when the member or the member's firm also performs for that client:
 - a. An audit or review of a financial statement.
 - b. A compilation of a financial statement when the member expects, or reasonably might expect, that a third party will use the financial statement and the member's compilation report does not disclose a lack of independence.
 - c. An examination of prospective financial information.
2. This prohibition applies during the period in which the member is engaged to perform any of the services listed above and the period covered by any historical financial statements involved in such listed services.

3. Disclosure of permitted commissions. A member in public practice who is not prohibited by this rule from performing services for or receiving a commission and who is paid or expects to be paid a commission shall disclose that fact to any person or entity to whom the member recommends or refers a product or service to which the commission relates.
4. Referral fees. Any member who accepts a referral fee for recommending or referring any service of a CPA to any person or entity or who pays a referral fee to obtain a client shall disclose such acceptance or payment to the client.

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Clients look to their CPAs for objective advice on the purchase of products and services, including services from other CPAs. CPAs who perform one or more of the services in point 1 are prohibited from accepting a commission from the providers of such products and services. However, CPAs who do not perform any of the services may receive such a commission if disclosure is made to the client. As an example, CPAs that do not perform financial statement audits, reviews, certain compilations, or examinations of prospective information for a client may receive commissions for purchasing and selling securities for that client, provided they disclose the existence of the commissions to the client.

Advertising and Other Forms of Solicitation Rule

Advertising and Other Forms of Solicitation Rule: A member in public practice shall not seek to obtain clients by advertising or other forms of solicitations in a manner that is false, misleading, or deceptive. Solicitation by the use of coercion, overreaching, or harassing conduct is prohibited.

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For many years, advertising by CPAs was strictly forbidden by the AICPA rules. However, this prohibition was dropped because it was deemed a possible violation of federal antitrust laws. Members of the public accounting profession may advertise their services so long as the advertising is not false, misleading, or deceptive. Unethical advertising includes that which creates unjustified expectations of favorable results or indicates an ability to influence a court or other official body.

Acceptable advertising is that which is informative and based upon verifiable fact. Indications of the types of services offered, certificates and degrees of members of the firm, and fees charged for services are all acceptable forms of advertising.

Confidential Client Information Rule

Confidential Client Information Rule: A member in public practice shall not disclose any confidential client information without the specific consent of the client.

This rule shall not be construed (1) to relieve a member of the member's professional obligations of the Compliance with Standards Rule or the Accounting Principles Rule, (2) to affect in any way the member's obligation to comply with a validly issued and enforceable subpoena or summons, or to prohibit a member's compliance with applicable laws and government regulations, (3) to prohibit review of a member's professional practice under AICPA or state CPA society or Board of Accountancy authorization, or (4) to preclude a member from initiating a complaint with or responding to any inquiry made by the professional ethics division or trial board of the Institute or a duly constituted investigative or disciplinary body of a state CPA society or Board of Accountancy. Members of any of the bodies identified in (4) above and members involved with professional practice reviews identified in (3) above shall not use to their own advantage or disclose any member's confidential client information that comes to their attention in carrying out those activities. This prohibition shall not restrict members' exchange of information in connection with the investigative or disciplinary proceedings described in (4) above or the professional practice reviews described in (3) above.

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This rule stresses the confidential nature of information obtained by CPAs from their clients. The nature of accountants' work makes it necessary for them to have access to their clients' most confidential financial affairs. Independent accountants may thus gain insider knowledge of impending business combinations, proposed financing, prospective stock splits or dividend changes, contracts being negotiated, and other confidential information that, if disclosed or otherwise improperly used, could bring the accountants quick monetary profits. Of course, the client could be financially injured, as well as embarrassed, if the CPAs were to "leak" such information. Any loose talk by independent public accountants concerning the affairs of their clients would immediately brand them as lacking in professional ethics. On the other hand, the confidential relationship between the CPA and the client is not a justification for the CPA to cooperate in any deceitful act. The personal integrity of the CPA is essential to the performance of the attest function.

Reporting Illegal Acts



When auditors identify noncompliance or suspected noncompliance with laws and regulations (sometimes referred to as NOCLAR), they should be particularly aware of their responsibilities relating to confidential client information (ET 1.700), and the interpretation of the Integrity and Objectivity Standard, which directly addresses the proper actions to be taken (ET 1.170). In essence, auditors are required to obtain an understanding of the matter, including its nature and the circumstances in which it occurred or is likely to occur, and discuss the matter with management (generally at least one level above those involved) and, if appropriate, those charged with governance. There often are issues about the need for financial statement disclosures related to such matters.

Should auditors be required to report illegal acts by clients to regulatory agencies? The confidential relationship rule prohibits CPAs from directly disclosing such information to outside parties, unless the auditors have a legal duty to do so. An amendment of the Securities Exchange Act of 1934, the Private Securities Litigation Reform Act of 1995, includes a requirement for fraud reporting, or *whistleblowing*, by the auditors. The requirements of this law apply when the client has committed an illegal act and (a) it has a material effect on the financial statements, (b) senior management and the board of directors have not taken appropriate remedial action, and (c) the failure to take remedial action is reasonably expected to warrant a departure from a standard audit report, or resignation by the auditors. In these circumstances, the auditors must, *as soon as practicable*, communicate their conclusions directly to the client's board of directors. Within one day, the management of the client must send a notification to the Securities and Exchange Commission of having received such a communication from the auditors, and a copy of the notification should be sent to the auditors. If the auditors do not receive a copy of the notification within the one-day period, they have one day to *directly communicate* the matter to the SEC.

Auditors also are required to communicate illegal acts in other situations. When illegal activities cause the auditors of a public company to lose faith in the integrity of senior management, they will resign and management must then file a Form 8-K, which discloses the reasons for the auditors' resignation. The auditors must then file a response to the filing indicating whether they agree with management's reasons and provide the details when they disagree. In addition, when the auditors are performing an audit in accordance with the Single Audit Act, they may be required to disclose illegal acts by the client to an agency that provides federal financial assistance to the client. Single audits are described in detail in Chapter 21. ET 1.170 provides more details on CPA responsibilities relating to illegal acts when performing attestation services (such as financial statement audits) or other nonattestation services. ET 2.170 addresses responsibilities of CPAs in business settings other than public accounting.

Confidentiality versus Privileged Communication

The communications between CPAs and their clients are confidential, but they are not *privileged* under common law, as are communications with attorneys, clergymen, or physicians. The difference is that disclosure of legally **privileged communication** cannot be required by a subpoena or court order. Thus, CPAs may be compelled to disclose

their communications with clients in certain types of court proceedings. Some individual states, however, have adopted statutes providing that public accountants cannot be required by the state courts to give evidence gained in confidence from clients. But state laws do not apply to federal courts where there is not privileged communication.

Form of Organization and Name Rule

Form of Organization and Name Rule:

1. A member may practice public accounting only in a form of organization permitted by state law or regulation, whose characteristics conform to resolutions of Council.
2. A member shall not practice public accounting under a firm name that is misleading.
3. Names of one or more past owners may be included in the firm name of a successor organization.
4. A firm may not designate itself as "Members of the American Institute of Certified Public Accountants" unless all of its owners are members of the AICPA.

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The *Code of Professional Conduct* allows CPAs to practice in any legal business form. This includes the ability to practice as professional corporations, limited liability partnerships (companies), partnerships, or sole practitioners.

Professional corporations have certain tax advantages not available to partnerships, such as tax deductibility of pension and profit-sharing plans. The shareholders of professional corporations retain liability for acts of the corporation, regardless of whether they participated in the engagement resulting in the liability. Besides providing for financial liability, the organization must be established such that two-thirds ownership, voting rights, and control over professional matters must rest with individuals authorized to practice public accounting. Previously, the *Code* prohibited public accountants from practicing under a name that was fictitious or indicated a specialization. Because this prohibition was sensitive to antitrust attack, the rule now allows fictitious names so long as they are not false, misleading, or deceptive.

The *Code* also allows CPA firms to form various affiliations between firms. As indicated in Chapter 1, CPA firms often form such affiliations among themselves to enhance their capabilities to provide professional services.¹⁰

Alternative Practice Structures

As indicated in Chapter 1, public accounting firms are entering into what is referred to as "alternative practice structures" in which publicly traded companies (e.g., CBIZ, Inc., and H&R Block) purchase public accounting firms. A typical alternative practice arrangement may be as follows:

- Public Company buys the nonattest portion of a public accounting firm's practice from the public accounting firm's partners for cash, stock, or a combination of both.
- Public Company has subsidiaries such as a bank, an insurance company, a broker-dealer, and a professional services subsidiary that offer clients the nonattest public accounting services.
- Public accounting firm partners and employees become employees of Public Company, performing nonattest public accounting work under the Public Company name.
- The attest practice of the public accounting firm remains intact with the "shell" of the public accounting firm and continues to be owned by the original partners of the public accounting firm (who are now also employees of Public Company).
- The public accounting firm leases staff from Public Company to perform the attest services.

¹⁰ When such an affiliation qualifies as a "network" as defined in the *Code of Professional Conduct* (e.g., common control among the firms, common brand name, and sharing of profits), members of a network firm are required to comply with the Independence Rule. Further details, presented in Section 1.220.010 of the *Code of Professional Conduct*, are beyond the scope of our discussion.

FIGURE 3.13 Illustration of an Alternative Practice Structure

	Public Company	CPA Firm
Structure	Publicly traded corporation owned by stockholders	Partnership or other form of organization authorized to perform audit and attest services owned by the partners
Services performed	Nonattest services	Audit and attest services
Staffing of engagements	Partners and staff who are now employees of the public company	Partners and staff time are leased from the public company
Management of the practice	Practice is managed by officers of the public company	Practice is managed by partners of the CPA firm

Figure 3.13 summarizes the typical structures of these types of firms.

Alternative practice structures present a number of questions and potential threats to independence. For example, because the partners of the attest firm are employees of Public Company, these partners may have a difficult time maintaining independence when auditing a client that is important to Public Company. To illustrate, pressure may be exerted by Public Company management to issue a standard unqualified report when there is substantial doubt concerning going concern status relating to a client that has a significant debt to Public Company. Or perhaps Public Company may provide attest clients with services that place personnel in a position equivalent to that of client management.

Code of Professional Conduct: Applicability to Members in Business and Others

LO 3-8

Discuss *Code of Professional Conduct* applicability to members not in public practice and describe overall *Code* enforcement.

Members in Business

In addition to applying to members in public practice, the AICPA *Code of Professional Conduct* also is applicable to (1) members in business and (2) other members, such as those who are retired or unemployed.

The *Code* for business members is similar to that for those in the practice of public accounting in that it presents a conceptual framework to address threats and safeguards relating to compliance with the *Code* and a number of rules. The conceptual framework is similar to that we discussed for those in public practice with the following exceptions:

- The independence and management participation threats that a member in practice faces are not included in the conceptual framework threats for business members. Independence is excluded because it is specific to a member in practice who provides attest services. A management participation threat is inappropriate for those in business because they may well be a part of the management of a business.
- The other threats are in title the same as for those in practice (e.g., adverse interest threat, advocacy threat) but modified in application to a business setting.
- The safeguards for accountants in business are those (1) created by the profession, legislation, or regulation and (2) implemented by the employing organization. Recall that members in practice also have safeguards implemented by the attest client.

The *Code* then presents the relevant rules for those in business. As indicated in Figure 3.4, there are five rules—integrity and objectivity, general standards, compliance with standards, accounting principles, and acts discreditable to the profession. All of these rules are implemented in a business setting rather than a public accounting context.

Other Members (Retired and Unemployed)

No conceptual framework is included for these members, and as indicated in Figure 3.4, other members are only under the acts discreditable rule. Examples of such possible acts for these members include (1) discrimination and harassment in employment practices, (2) solicitation or disclosure of CPA exam questions and answers, (3) failure to file a tax return or to pay a tax liability, (4) inappropriate release of confidential information, and (5) inappropriate acts in promoting or marketing services or use of the CPA credential.

Enforcement of Professional Ethics

The AICPA and the state societies of CPAs have established a joint ethics enforcement plan to enforce professional ethics. The process ordinarily begins with a written complaint (by anyone) to an ethics committee, a participating state society, or the AICPA that alleges that a member or a firm has or may have violated an applicable *Code of Professional Conduct* rule.

Depending upon the requirements of a state society's bylaws, a number of approaches are possible. Although complaints with a national interest are often first considered by the Professional Ethics Division, complaints, in general, may be investigated at either the state or the Division level. If the state or Division finds a particular complaint to be valid, it may take several courses of action. For minor violations, direct remedial action may be taken, such as requiring the member to get additional continuing education. More serious violations are turned over to the joint trial board for a hearing. If found guilty, the offending member may be censured, suspended from membership for up to two years, or expelled permanently from the AICPA. Although expulsion from the AICPA would not in itself cause the loss of a CPA's license, the damage to the CPA's professional reputation would be substantial.

The provisions of the AICPA rules have been used as a model by the boards of accountancy throughout the country to develop the ethical standards in their states. Thus, revocation of the CPA's license to practice also is a possible consequence of violation of the AICPA ethical standards.

Finally, ethical violations by auditors of public companies also are investigated and enforced by the SEC and the Public Company Accounting Oversight Board. Severe violations may result in suspension of the CPA's or the public accounting firm's right to practice as an auditor of public companies. Lesser penalties may involve monetary fines or remedial measures, such as the required implementation of new quality management (control) procedures.

The International Code of Ethics for Professional Accountants

As indicated in Chapter 1, the International Federation of Accountants (IFAC) has established the International Ethics Standards Board for Accountants to establish international ethical standards, titled the *Code of Ethics for Professional Accountants*. In general, the provisions of the international *Code of Ethics for Professional Accountants* is quite similar to the provisions of the AICPA *Code of Professional Conduct*.

The international ethics rules regarding independence in audit and review engagements are similar to the AICPA rules. Both require the concepts of independence in mind and in appearance. However, the international ethics rules have fewer definitive prohibitions. Like the AICPA *Code*, when there is no definitive prohibition, the following conceptual approach is used:

1. Identify threats to independence;
2. Evaluate the significance of the threats identified; and
3. Apply safeguards, when necessary, to eliminate the threats or reduce them to an acceptable level. If safeguards do not reduce the risk to an acceptable level, the firm should not accept or continue the engagement, or assign the particular individual to the engagement team. The firm should document these considerations and the conclusion. Threats to independence arise from self-interest, self-review, advocacy, familiarity, or intimidation.

International rules regarding confidentiality and fee arrangements are also not as specific as AICPA rules because laws and regulations regarding such matters vary from country to country.

Ethics for Internal Auditors

LO 3-9

Discuss the Institute of Internal Auditors ethical standards.

Internal auditors, acting through their national organization, The Institute of Internal Auditors, have developed their own ethical standards. Historically, The Institute of Internal Auditors had a *Code of Ethics* that described internal auditor obligations, primarily to their employers, but also included requirements for integrity, objectivity, confidentiality, and competency in the practice of internal auditing—that code is included in the text’s Appendix.

In 2023, the Institute of Internal Auditors exposed or public comment a new set of professional standards that include both ethical principles and other professional standards. The ethics section, titled Ethics and Professionalism, includes requirements to

1. Demonstrate Integrity,
2. Maintain Objectivity,
3. Demonstrate Competency, and
4. Exercise Due Professional Care.

The final standards are effective at the end of 2024. Violation of the ethical standards could result in revocation of the auditor’s membership in The Institute of Internal Auditors or forfeiture of the auditor’s “Certified Internal Auditor” designation. Professional standards are described in more detail in Chapter 21.

Chapter Summary

This chapter explained the need for professionals to adhere to high standards of professional conduct and described the details of the codes of ethics that apply to both external and internal auditors. To summarize:

1. Ethics are the moral principles and values that govern the behavior of individuals and groups. An *ethical dilemma* is a situation that involves a decision about appropriate behavior. A key aspect of an ethical dilemma is that, in addition to the decision maker, it generally affects parties that are not involved in the decision. For example, if management of a corporation decides to pollute the environment, it affects all of the members of society. Professional accountants are faced with difficult personal and professional ethical dilemmas on a daily basis.
2. Among the characteristics common to recognized professions are (a) acknowledgment of a responsibility to serve the public, (b) existence of a complex body of knowledge, (c) standards of admission to the profession, and (d) a need for public confidence.
3. The membership of the AICPA has adopted the *Code of Professional Conduct*, consisting of two sections—Principles and Rules. In addition, the AICPA issues Interpretations and nonauthoritative guidance to assist CPAs in determining appropriate ethical conduct.
4. Independence is required when CPAs perform audits and other types of attest engagements. The AICPA *Conceptual Framework for Independence* provides a risk-based approach for considering threats and safeguards related to independence. The Independence Rule and its Interpretations provide guidance on various financial and business relationships that may impair a CPA’s independence. That standard prohibits all direct financial interests in a client, as well as material indirect financial interests. Certain independence requirements apply only to covered members, and others apply to all partners and professional employees. In the audit of a public company, the auditors also must adhere to the ethics and independence requirements of the SEC, the Sarbanes-Oxley Act of 2002, and the Public Company Accounting Oversight Board.

5. The rules of the AICPA *Code of Professional Conduct* set forth the professional standards that must be followed by CPAs when performing various types of professional services. For example, the Compliance with Standards Rule requires auditors to adhere to *Statements on Auditing Standards*. Accounting standards of the FASB, the GASB, the IASB, and the FASAB are enforced by the Accounting Principles Rule.
6. In performing an audit, the auditors have access to the details of the client's most confidential information. If the auditors disclosed this information, they might damage their clients' businesses. Therefore, CPAs are required to maintain a confidential relationship with their clients.
7. CPAs generally may accept engagements for contingent fees and receive commissions for referrals, but only if they do not also provide certain attestation or compilation services for the client.
8. A public accounting firm may practice public accounting in any form of organization permitted by law or regulation, including as a sole practitioner, partnership, professional corporation, or limited liability partnership (company).
9. The ethical standards of The Institute of Internal Auditors primarily address internal auditors' obligations to their employers, but they also includes provisions requiring integrity, objectivity, confidentiality, and competency in the practice of internal auditing.

Key Terms Introduced or Emphasized in Chapter 3

Acceptable level of risk of noncompliance (90) A situation in which a reasonable and informed third party who is aware of the relevant information would be expected to conclude that a member's ability to comply with the rules is not compromised. For independence, this is referred to as the acceptable level of risk to independence.

Attest engagement team (93) Consists of individuals participating in the attest engagement, including those who perform concurring and second partner reviews. The attest engagement team includes all employees and contractors retained by the firm who participate in the attest engagement, irrespective of their functional classification (e.g., audit, tax, or management consulting services), except specialists as discussed in the professional standards and individuals who perform only routine clerical functions, such as word processing and photocopying.

Audit committee (104) A committee of a corporation's board of directors that engages, compensates, and oversees the work of the independent auditors; monitors activities of the internal auditing staff; and intervenes in any disputes between management and the independent auditors. Members of the audit committee must be independent directors, that is, members of the board of directors who do not also serve as corporate officers or have other relationships that might impair independence.

Close relative (97) A parent, sibling, or nondependent child.

Covered member (92) A covered member may be (a) an individual on the attest engagement team; (b) an individual in a position to influence the attest engagement; (c) a partner, partner equivalent, or manager who provides nonattest services to the attest client beginning once he or she provides 10 hours of nonattest services to the client within any fiscal year and ending on the latter of the date (1) the firm signs the report on the financial statements for the fiscal year during which those services were provided or (2) he or she no longer expects to provide 10 or more hours of nonattest services to the attest client on a recurring basis; (d) a partner or partner equivalent in the office in which the lead attest engagement partner or partner equivalent primarily practices in connection with the attest engagement; (e) the firm, including the firm's employee benefit plans; or (f) an entity whose operating, financial, or accounting policies can be controlled by any of the individuals or entities described in (a) through (e) or by two or more such individuals or entities if they act together.

Direct financial interest (95) A personal investment under the direct control of the investor. The *Code of Professional Conduct* prohibits CPAs from having any direct financial interests in their attest clients. Investments made by a CPA's spouse or dependents also are regarded as direct financial interests of the CPA.

Ethical conflict (81) An ethical dilemma. As defined in the AICPA *Code of Professional Conduct*, a situation in which an individual encounters obstacles in deciding an appropriate course of action due to internal or ethical pressures or when conflicts exist in applying relevant professional standards, to legal standards, or both.

Ethical dilemma (81) Also referred to as a moral dilemma or ethical conflict, it is a situation in which there is a choice to be made between two options, neither of which resolves the situation in an ethically acceptable fashion. To follow one option makes it impossible to follow the other option.

Financial interest (95) An ownership interest in an equity or a debt security issued by an entity, including the rights and obligations to acquire such an interest and derivatives directly related to such interest. See also direct financial interest and indirect financial interest.

Immediate family member (96) A spouse, spousal equivalent, or dependent (whether or not related).

Impaired independence (92) When independence is effectively extinguished. That is, when an auditor's independence is impaired, that auditor is not independent.

Independence (91) Independence includes two concepts—*independence of mind* and *independence in appearance*.

Independence in appearance (91) The avoidance of circumstances that would cause a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or a member of the attest engagement team has been compromised.

Independence of mind (91) The state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.

Indirect financial interest (95) A financial interest owned through an intermediary (e.g., a mutual fund) when the CPA neither controls the intermediary nor has the authority to supervise or participate in the intermediary's investment decisions. An example is an investment in a professionally managed mutual fund. The *Code of Professional Conduct* allows CPAs to have indirect financial interests in attest clients, as long as the investment is not material in relation to the CPA's net worth.

Individual in a position to influence the attest engagement (93) An individual who (a) evaluates the performance or recommends the compensation of the attest engagement partner; (b) directly supervises or manages the attest engagement partner, including all successively senior levels above that individual through the firm's chief executive; (c) consults with the attest engagement team regarding technical or industry-specific issues related to the attest engagement; or (d) participates in or oversees at all successively senior levels quality control activities, including internal monitoring, with respect to the specific attest engagement.

Interpretations (86) Guidelines issued by the AICPA for the scope and application of the Rules of Conduct.

Joint closely held investment (96) An investment in an entity or property by the member and the attest client (or the attest client's officers or directors, or any owner who has the ability to exercise significant influence over the attest client) that enables them to control the entity or property.

Key position (97) A position in which an individual has (a) primary responsibility for significant accounting functions that support material components of the financial statements; (b) primary responsibility for the preparation of the financial statements; or (c) the ability to exercise influence over the contents of the financial statements, including when the individual is a member of the board of directors, or similar governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position. For purposes of *attest engagements* not involving *financial statements*, a key position is one in which an individual is primarily responsible for, or able to influence, the subject matter of the *attest engagement*, as previously described.

Manager (93) A professional employee of the public accounting firm who has continuing responsibility for the planning and supervision of engagements for specified clients.

Off-the-shelf software (101) Commercially available software created for a variety of users in the same industry or with the same application.

Partner equivalent (93) A professional employee who is not a partner of the firm but who has the ultimate responsibility for an attest engagement or has the authority to bind the CPA firm to conduct an attest engagement without partner approval. For example, assume a CPA firm employee is a manager who functions as a partner in that she has ultimate responsibility for several engagements—this employee is a partner equivalent.

Period of the professional engagement (94) A period that begins when a member either signs an initial engagement letter or other agreement to perform attest services or begins to perform an attest engagement for a client, whichever is earlier. The period lasts for the entire duration of the professional relationship (which could cover many periods) and ends with the formal or informal notification, by

either the member or the client, of the termination of the professional relationship or by the issuance of a report, whichever is later. Accordingly, the period does not end with the issuance of a report and recommence with the beginning of the following year's attest engagement.

Principles (86) The part of the AICPA *Code of Professional Conduct* that expresses the profession's responsibilities to the public, clients, and colleagues and provides a framework for the rules.

Privileged communication (112) A confidential legally protected communication between a person making the communication and the person receiving it. For example, communications between clients and their lawyers. The rationale here is that clients should be able to communicate freely with their lawyers. Privileged communications are controversial because they exclude relevant facts from the truth-seeking process. While the AICPA *Code of Professional Conduct* creates a confidential relationship between CPAs and their clients, CPAs do not in general have privileged communication, a legal concept, with their clients other than in particular state court systems. CPAs do not have privileged communication in federal courts.

Profession (85) An activity that involves a responsibility to serve the public, has a complex body of knowledge, has standards for admission, and has a need for public confidence.

Prospective financial information (110) Presentations of future financial position, results of operations, or cash flows. Such presentations are often referred to as financial forecasts or projections.

Rules (86) A group of enforceable ethical standards included in the AICPA *Code of Professional Conduct*.

Safeguards (to independence) (90) Controls that mitigate or eliminate threats to independence. Safeguards range from partial to complete prohibitions of the threatening circumstance to procedures that counteract the potential influence of a threat.

Significant influence (97) The criteria established in accounting standards to determine the ability of an investor to exercise significant influence over another entity. In general, these criteria include an ownership interest of 20 percent or more of the entity.

Threats (88) Circumstances not directly addressed by the *Code of Professional Conduct* that could result in member noncompliance with the *Code*. The AICPA's list of broad categories of threats include (1) adverse interest, (2) advocacy, (3) familiarity, (4) self-interest, (5) self-review, (6) undue influence, and, for those in public practice, (7) management participation.

Review Questions

- 3-1. What is meant by the term *ethical dilemma*? Describe an ethical dilemma that you have faced.
- 3-2. What are the two major types of constraints on decisions that involve ethical issues? Provide examples of each type.
- 3-3. What is the basic purpose of a code of ethics for a profession?
- 3-4. Describe the relationships among the AICPA *Code of Professional Conduct*'s principles, rules, and interpretations.
- 3-5. List the broad categories of threats to independence included in the AICPA *Conceptual Framework for Independence Standards*.
- 3-6. How does the AICPA *Code of Professional Conduct* relate, if at all, to *Statements on Auditing Standards*?
- 3-7. Explain how a CPA might have an indirect financial interest in an audit client. Does the AICPA *Code of Professional Conduct* prohibit such interests?
- 3-8. Jim Willingham works as a manager in the Phoenix office of an international public accounting firm. His younger brother has just taken a position as a purchasing agent for one of the public accounting firm's Phoenix clients. Has Jim's independence been impaired with respect to this audit client? Has the public accounting firm's independence been impaired if Jim does not work on the audit?
- 3-9. Three months ago, a national public accounting firm hired Greg Scott to work as a staff auditor in its New York office. Yesterday, Scott's father was hired to be the chief financial officer of one of the public accounting firm's New York office clients. Has the independence of the public accounting firm with respect to this client been impaired?
- 3-10. Sara Kole, CPA, has been requested by the president of Noyes Company, a closely held corporation and audit client, to cosign Noyes Company checks with the Noyes treasurer when the president is away on business trips. Use the *Code of Professional Conduct* (available at pub.aicpa.org/codeofconduct) to research and determine whether Kole would violate the public accounting profession's requirements if she accepted this request. Also, provide the reference for the most directly applicable ethics rule (e.g., ET 1.XXX.XXX).

- 3-11. With respect to ethics, what are the responsibilities of the Public Company Accounting Oversight Board? What is the source of the Board's authority?
- 3-12. Describe what is meant by the term "covered member."
- 3-13. How do the rules for the audit of public versus nonpublic companies differ with respect to the independence of a CPA who performs routine accounting services for a client?
- 3-14. Which rules of the AICPA *Code of Professional Conduct* recognize the PCAOB as a body authorized to issue technical standards?
- 3-15. Use the AICPA *Code of Professional Conduct* (available at pub.aicpa.org/codeofconduct) to identify the circumstances under which a CPA may *not* perform professional services on a contingent fee basis. Cut and paste the most directly relevant rule from the *Code*.
- 3-16. Jian Zhang is a CPA who often serves as an expert witness in court cases. Is it proper for Zhang to receive compensation in a damage suit based on the amount awarded to the plaintiff? Discuss.
- 3-17. Sandy Schultz, CPA, has performed a consulting services job in which she made recommendations that ultimately resulted in one of her audit clients purchasing a new information system manufactured by the AMZ Computer Corporation. Shortly thereafter, Ms. Schultz was surprised when she received a \$1,000 unsolicited commission from AMZ Computer Corporation. Would acceptance of this commission violate the AICPA *Code of Professional Conduct*? Explain.
- 3-18. Laura Clark, wife of Jon Clark, CPA, is a life insurance agent. May Jon Clark refer audit clients needing officer life insurance to Laura Clark or to another life insurance agent who will share a commission with Laura Clark? Explain.
- 3-19. In what organizational forms may CPAs practice public accounting?
- 3-20. Must a CPA maintain independence and an impartial mental attitude when preparing a client's income tax return? Explain.
- 3-21. The AICPA *Code of Professional Conduct* includes rules in various areas. Which of those rules apply to CPAs not in public practice but in business or other positions (e.g., retired or unemployed)?
- 3-22. In what circumstances are the various conceptual frameworks within the *Code of Professional Conduct* considered by accountants?
- 3-23. In preparing a client's income tax return, a CPA feels that certain expenses are unreasonably high and probably are overstated. Explain the CPA's responsibilities in this situation.
- 3-24. What board establishes international ethical standards for accountants? How do these standards compare to the AICPA *Code of Professional Conduct*?
- 3-25. "Since internal auditors are employees, they have no ethical responsibilities to others beyond their employers." Comment on this statement.
- 3-26. The Institute of Internal Auditors has developed ethical standards for internal auditors. List the four topical areas of these standards.

Questions Requiring Analysis LO 3-5, 6

LO 3-5

- 3-27. Sally Adams is an audit manager for the firm of Jones & Smith, CPAs, and is assigned to the audit of Libra Fashions, Inc. Near the middle of the audit, Sally was offered the job of Libra's chief financial officer.
 - a. Discuss the implications of this offer assuming Libra is a nonpublic corporation.
 - b. Discuss the implications of this offer assuming Libra is a public company.
- 3-28. Roger Royce, CPA, has encountered a situation that he thinks may pose a threat to his independence with respect to Watson, Inc., an audit client. The situation is not addressed by an independence rule or regulation. Using the AICPA *Conceptual Framework for Independence Standards*, describe how Royce can determine whether the threat truly impairs his independence.

LO 3-5

- 3-29. Jenko Corp. is an audit client of the Phoenix office of Williams and Co., CPAs. Williams and Co. has offices in Arizona, including ones in Phoenix, Tucson, and Tombstone. For purposes of independence, the AICPA requires that no "covered member" may have a direct or a material indirect financial interest in an audit client such as Jenko. Determine whether each of the following individuals is a covered member.
 - a. Bill Jones is a partner in the Tucson office of Williams. He does not work on the Jenko audit.
 - b. Mary Adams is a first-year staff assistant who works on the Jenko audit.



- c. Mary Anderson is a partner in the Phoenix office of Williams. She does not work on the Jenko audit.
 - d. Bill Jepson, a staff auditor who does not work on the audit, owns an immaterial amount of stock of Jenko Corp.
 - e. Ken Sanders, a Tombstone office partner, provides no services for the Jenko audit other than serving as a consultant to the attest team regarding industry-related issues specific to Jenko.
- LO 3-5** 3–30. The firm of Williams, Kline & Chow, CPAs, is the auditor of Yuker Corporation, a nonpublic company. The president of Yuker, Karen Lester, has been putting pressure on Chee Chow, the audit partner, to accept a questionable accounting principle. She has even threatened to take steps to replace the CPA firm if he does not acquiesce. Does this situation impair the CPA firm's independence? Explain your answer.
- LO 3-5** 3–31. Tracy Smith, CPA, is in charge of the audit of Olympic Fashions, Inc. Seven young members of the public accounting firm's professional staff are working with Smith on this engagement, and several of the young auditors are avid skiers. Olympic Fashions owns two condominiums in Aspen, Colorado, that it uses primarily to entertain clients. The controller of Olympic Fashions has told Smith that she and any of her audit staff are welcome to use the condominiums at no charge any time that they are not already in use. How should Smith respond to this offer? Explain.
- LO 3-4, 5** 3–32. Harris Fell, CPA and member of the AICPA, was engaged to audit the financial statements of Wilson Corporation. Fell had half-completed the audit when he had a dispute with the management of Wilson Corporation and was discharged. Hal Compton, CPA, was promptly engaged to replace Fell. Wilson Corporation did not compensate Fell for his work to date; therefore, Fell refused to allow Wilson Corporation's management to examine his working papers. Some of the working papers consisted of adjusting journal entries and supporting analysis. Wilson Corporation's management had no other source for this information. Did Fell violate the AICPA *Code of Professional Conduct*? Explain fully.
- LO 3-4** 3–33. Ron Barber, CPA, is auditing the financial statements of DGF, Inc., a publicly held company. During the course of the audit, Barber discovered that DGF has been making illegal bribes to foreign government officials to obtain business, and he reported the matter to senior management and the board of directors of DGF.
- a. If management and the board of directors take appropriate remedial action, should Barber be required to report the matter outside the company?
 - b. Describe Barber's appropriate response if management and the board of directors fail to take appropriate remedial action.
- LO 3-5** 3–34. Bill Jones is a partner with Adelson & Co., a one-office CPA firm located in Tucson, Arizona. He is the engagement partner on the audit team of NRG, LTD, a public company, and he has just discovered that his wife Sophia owns 100 shares of NRG, shares worth \$10 each.
- a. What effect, if any, does Sophia's investment have on the independence of Bill and Adelson & Co.?
 - b. Briefly describe the SEC's requirements that might lead to a conclusion that the firm is able to maintain independence in this situation.
 - c. Briefly describe the PCAOB's requirements that might lead to a conclusion that the firm is able to maintain independence in this situation.

Objective Questions

Select questions are available with Connect.



3–35. Multiple Choice Questions

Select the best answer for each of the following. Explain the reasons for your selection.

- LO 3-5**
- a. Which of the following is not a covered member for an attest engagement under the Independence Rule of the AICPA *Code of Professional Conduct*?
 - (1) An individual assigned to the attest engagement.
 - (2) A partner in the office of the partner in charge of the attest engagement.
 - (3) A manager who is in charge of providing tax services to the attest client.
 - (4) A partner in the national office of the firm that performs marketing services.

LO 3-7

- b. Which of the following is not prohibited by the AICPA *Code of Professional Conduct*?
- (1) Advertising in newspapers.
 - (2) Payment of commission to obtain an audit client.
 - (3) Acceptance of a contingent fee for a review of financial statements.
 - (4) Engaging in discriminatory employment practices.

LO 3-7

- c. In which of the following situations would a public accounting firm have violated the AICPA *Code of Professional Conduct* in determining its fee?
- (1) A fee is based on whether or not the public accounting firm's audit report leads to the approval of the client's application for bank financing.
 - (2) A fee is to be established at a later date by the Bankruptcy Court.
 - (3) A fee is based upon the nature of the engagement rather than upon the actual time spent on the engagement.
 - (4) A fee is based on the fee charged by the client's former auditors.

LO 3-5

- d. A public accounting firm would *least* likely be considered in violation of the AICPA Independence Rule in which of the following instances?
- (1) A partner's checking account, which is fully insured by the Federal Deposit Insurance Corporation, is held at a financial institution for which the public accounting firm performs attest services.
 - (2) A manager of the firm donates services as vice president of a charitable organization that is an audit client of the firm.
 - (3) An attest client owes the firm fees for last year's annual audit.
 - (4) A covered member's dependent son owns stock in an attest client.

LO 3-7

- e. Which of the following is implied when a CPA signs the preparer's declaration on a federal income tax return?
- (1) The return is not misleading based on all information of which the CPA has knowledge.
 - (2) The return is prepared in accordance with generally accepted accounting principles.
 - (3) The CPA has audited the return.
 - (4) The CPA maintained an impartial mental attitude while preparing the return.

LO 3-7

- f. The AICPA *Code of Professional Conduct* states that a CPA shall not disclose any confidential information obtained in the course of a professional engagement except with the consent of the client. This rule may preclude a CPA from responding to an inquiry made by:
- (1) An investigative body of a state CPA society.
 - (2) The trial board of the AICPA.
 - (3) A CPA-shareholder of the client corporation.
 - (4) An AICPA quality review body.

LO 3-7

- g. Which of the following is most likely to be a violation of the AICPA rules of conduct by Bill Jones, a sole practitioner with no other employees?
- (1) Jones performs consulting services for a percentage of the client's savings; these are the only services provided for the client.
 - (2) Jones names his firm Jones and Smith, CPAs.
 - (3) Jones advertises the services he provides in an Internet set of telephone "yellow pages."
 - (4) Jones, without client consent, makes available working papers for purposes of a peer review of his practice.

LO 3-7

- h. Bill Adams, CPA, accepted the audit engagement of Kelly Company. During the audit, Adams became aware of his lack of competence required for the engagement. What should Adams do?
- (1) Disclaim an opinion.
 - (2) Issue an adverse opinion.
 - (3) Suggest that Kelly Company engage another CPA to perform the audit.
 - (4) Rely on the competence of client personnel.

LO 3-6

i. Which of the following nonattest services may be performed by the auditors of a public company?

- (1) Internal audit outsourcing.
- (2) Tax planning for all company officers.
- (3) Bookkeeping services.
- (4) Preparation of the company's tax return.

LO 3-5

j. In providing nonattest services to an attest client, a CPA is allowed to perform which of the following functions?

- (1) Maintaining custody of the client's securities.
- (2) Training client employees.
- (3) Supervising client employees.
- (4) Acting as the third approver of large client expenditures.

LO 3-7, 8

k. The Compliance with Standards Rule requires CPAs to adhere to all of the following applicable standards, except:

- (1) Statements on Standards for Consulting Services.
- (2) Statements on Auditing Standards.
- (3) Statements on Standards for Attestation Engagements.
- (4) Statements on Responsibilities for Assurance Services.

LO 3-9

l. A member's violation of Institute of Internal Auditor (IIA) ethical standards may result in:

Revocation of IIA membership	Forfeiture of Certified Internal Auditor designation
(1) Yes	Yes
(2) Yes	No
(1) No	Yes
(2) No	No

LO 3-4, 6, 7

3-36. Simulation

The firm of Wilson and Wiener (WW), CPAs, has had requests from a number of clients and prospective clients to perform various types of services. Please reply as to whether the appropriate independence rules (AICPA and/or PCAOB) allow the following engagements using the following key:

A—Allowable, given these facts.

N—Not allowable, given these facts.

(If both AICPA and PCAOB rules apply and one of them does not allow the services, answer N.)

Case Request	Public or Nonpublic Client	Allowable (A) or Not Allowable (N)?
a. Provide internal audit outsourcing, as well as perform the audit	Public	
b. Prepare the corporate tax return, as well as perform the audit	Public	
c. Prepare the corporate tax return, as well as perform the audit	Nonpublic	
d. Provide bookkeeping services, as well as perform the audit; WW will not determine journal entries, authorize transactions, or prepare or modify source documents	Nonpublic	
e. Provide financial information systems design and implementation assistance; WW provides no attest services for that company	Public	
f. Serve on the board of directors of the company; WW provides no attest services for the company	Public	
g. Implement an off-the-shelf accounting package, as well as perform the audit	Nonpublic	
h. Provide actuarial services related to certain liabilities, as well as perform the audit; the subjectively determined liabilities relate to a material portion of the financial statements	Nonpublic	
i. Provide actuarial services related to certain liabilities, as well as perform the audit; the subjectively determined liabilities relate to a material portion of the financial statements	Public	
j. Provide tax planning services for corporate executives of an audit client (not for the company)	Public	

- LO 3-7** 3–37. Donald Westerman is president of Westerman Corporation, a nonpublic manufacturer of kitchen cabinets. He has been approached by Darlene Zabish, a partner with Zabish and Co., CPAs, who suggests that her firm can design a payroll system for Westerman that will either save his corporation money or be free. More specifically, Ms. Zabish proposes to design a payroll system for Westerman on a contingent fee basis. She suggests that her firm’s fee will be 25 percent of the savings in payroll for each of the next four years. After four years Westerman will be able to keep all future savings. Westerman Corporation’s payroll system costs currently are approximately \$200,000 annually, and the corporation has not previously been a client of Zabish.
- Westerman discussed this offer with his current CPA, Bill Zabriski, whose firm annually audits Westerman Corporation’s financial statements. Zabriski states that this is a relatively simple task and that he would be willing to provide the service for \$30,000.
- Would Zabish violate the AICPA *Code of Professional Conduct* by performing the engagement?
 - Would Zabriski violate the AICPA *Code of Professional Conduct* by performing the engagement?
 - Now assume that Westerman has indicated to Zabriski that he is leaning toward accepting Zabish’s offer. Zabriski then offers to provide the service for 15 percent of Westerman’s savings for the next three years. Would performing the engagement in accordance with the terms of this offer violate the AICPA *Code of Professional Conduct*?
 - Now go back to the original information (do not consider Zabriski’s 15 percent offer in part c). If Westerman Corporation was a public company (“an issuer”), would Zabish violate PCAOB standards by performing the engagement?
 - Now go back to the original information (do not consider Zabriski’s 15 percent offer in part c). If Westerman Corporation was a public company (“an issuer”), would Zabriski violate PCAOB standards by performing the engagement?
- LO 3-5** 3–38. The firm of McGraw and West, CPAs, has two offices, one in Phoenix and one in San Diego. The firm has audited the Cameron Corporation out of its Phoenix office for the past five years. For each of the following independent cases, which occurred during the year under audit, indicate whether the independence of either (a) the CPA involved or (b) the firm would be impaired.
- Mary McGraw, a partner in the San Diego office, fell wildly in love with Bill Smith, the treasurer for Cameron Corporation. They were married in Las Vegas. During the week, McGraw still lives in San Diego and works in that office, while Bill Smith lives in Phoenix, working for Cameron. On weekends they commute to their home in Yuma. Mary does not participate in the engagement.
 - Jim West is the father of Will West, a Phoenix partner. Jim West has a material investment in Cameron. Will West is unaware of his father’s investment but does participate in the engagement.
 - Bill Johnson, a senior in the San Diego office, has a material investment in the capital stock of Cameron. He does not participate in the engagement.
 - Sandra Steversen, a staff assistant in the Phoenix office, works on the Cameron audit. Her uncle works as the chief accounting officer for Cameron.
 - Bill Adams, a senior in the Phoenix office, does not work on the Cameron audit but owns 9 percent of Cameron’s outstanding equity (common stock).
- LO 3-7** 3–39. The firm of Harwood & Toole, CPAs, has been the auditor and tax return preparer for Tucker, Inc., a nonpublic company, for several years. In the current year, the management of Tucker discharged Harwood & Toole from the audit and tax engagement because of a disagreement over a tax matter. Management of Tucker has not paid Harwood & Toole any of the current year’s audit and tax fees. Another CPA firm has been hired and management of Tucker has requested that Harwood & Toole provide the following items:
- Accounting records of Tucker, Inc., in the possession of Harwood & Toole.
 - Copies of adjusting entries prepared by the staff of Harwood & Toole.
 - A copy of Tucker’s partially completed tax return prepared by the staff of Harwood & Toole.
 - Copies of Harwood & Toole’s audit working papers from prior engagements.
 - Several consolidating entries prepared by Tucker, Inc., and reviewed by Harwood & Toole.

- Indicate which of the items must be provided to management of Tucker by Harwood & Toole.
- LO 3-7** 3–40. James Daleiden, CPA, is interested in expanding his practice through acquisition of new clients. For each of the following independent cases, indicate whether Daleiden would violate the AICPA *Code of Professional Conduct* by engaging in the suggested practice and explain why. If more information is needed to arrive at a final determination, indicate the nature of such information.
- Daleiden wishes to form a professional corporation and use the name “AAAAAAA the CPAs” to obtain the first ad in the yellow pages of the telephone book.
 - Daleiden wishes to prepare a one-page flyer that he will have his son stuff on the windshields of each car at the Pleasant Valley shopping mall. The flyer will outline the services provided by Daleiden’s firm and will include a \$50-off coupon for services provided on the first visit.
 - Daleiden has a thorough knowledge of the tax law. He has a number of acquaintances who prepare their own tax returns. He proposes to offer to review these returns before they are filed with the Internal Revenue Service. For this review, he will charge no fee unless he is able to identify legal tax savings opportunities. He proposes to charge each individual one-third of the tax savings he is able to identify.
 - Daleiden and his associates audit a number of municipalities. He proposes to contact other CPAs and inform them of his interest in obtaining more of these types of audits. He offers a \$500 “finder’s fee” to CPAs who forward business to him.
 - Daleiden wishes to advertise that if he is hired to perform the audit, he will discount his fees on tax services (he does intend to grant a discount).
- LO 3-5** 3–41. The firm of Bell & Greer, CPAs, has been asked to perform attest services for Trek Corporation (a nonpublic company) for the year ended December 31, Year 5. Bell & Greer has two offices: one in Los Angeles and the other in Newport Beach. Trek Corporation would be audited by the Los Angeles office. For each of the following cases, indicate whether Bell & Greer’s independence is definitely impaired. If it is not definitely impaired, but might be under some circumstances, discuss those circumstances.
- A partner in the Los Angeles office of Bell & Greer has been a long-time personal friend of the chief executive officer of Trek Corporation.
 - The former controller of Trek Corporation became a partner in the Newport Beach office of Bell & Greer on March 15, Year 5, resigning from Trek Corporation on that date.
 - A manager in the Newport Beach office of Bell & Greer is the son of the treasurer of Trek Corporation.
 - A partner in the Los Angeles office of Bell & Greer jointly owns a cattle ranch in Montana with one of the directors of Trek Corporation. The value of the investment is material to both parties.
 - Trek Corporation has not yet paid Bell & Greer for professional services rendered in Year 4. This fee is a very significant amount and is now 15 months past due.
- LO 3-5** 3–42. The firm of Schilling & Co., CPAs, has offices in Chicago and Green Bay, Wisconsin. Gillington Company, which has 1 million shares of outstanding stock, is audited by the Chicago office of Schilling; Welco, of the Chicago office, is the partner in charge of the audit. For each of the following circumstances, indicate whether the public accounting firm’s independence is impaired with respect to Gillington Company.
- Johnson, a partner in the Chicago office, owns 100 shares of the stock of Gillington. He has no responsibilities with respect to the Gillington audit.
 - Gizmo, a partner in the Green Bay office, owns 600 shares of the stock of Gillington. He has no responsibilities with respect to the Gillington audit.
 - Masterson is a staff assistant in the Green Bay office and owns 10 percent of Gillington’s outstanding common stock. Masterson provides no services to Gillington and is not able to influence the engagement.
 - Schilling, the partner in charge of the entire firm, works in the Green Bay office. He owns 100 shares of Gillington stock (market value \$2 per share) but provides no services on the engagement.
 - Gorman is a staff assistant on the audit. Gorman’s mother owns shares of Gillington that are material to her net worth and of which Gorman has knowledge.

LO 3-5 3–43. **Simulation**

Gloria and Deloria, CPAs, have recently started their public accounting firm and intend to provide attestation and a variety of consulting services for their clients, which are all nonpublic. Both Ms. Gloria and Mr. Deloria have particular expertise in designing payroll and other disbursement systems. Ms. Gloria is concerned about whether any of the following services would impair their audit independence.

- a. For each of the services in the accompanying table, provide a judgment as to whether providing the service would impair attest independence. In all 12 situations, assume that management has designated a management-level individual to be responsible for overseeing the CPA's services and has established appropriate internal control. Also assume that the client is privately held and does not report to the SEC.
- b. Now assume that the 12 services are being contemplated for nonattest clients. Which of the services does the AICPA *Code of Professional Conduct* prohibit under this assumption?

Situation Number	Service Description	Independence Impaired (Yes, No, Indeterminate)	Additional Information Needed for "Indeterminate" Replies
1	Customize and implement a prepackaged payroll system.		
2	Manage the portion of a client's local area network system related to payroll.		
3	Using payroll time records approved by management, generate unsigned payroll checks on a continuing basis for the client; the client signs the checks.		
4	Prepare the payroll tax return form and sign it on behalf of management.		
5	Approve employee time cards.		
6	Accept responsibility to sign checks, but only in emergency situations.		
7	Monitor employee time cards and make changes when errors are detected.		
8	Post client-approved entries to client's trial balance.		
9	Provide all the initial training and instruction to client employees on a newly implemented payroll information and control system.		
10	Screen candidates and recommend the most highly qualified candidate to serve as treasurer for the client.		
11	Supervise client personnel in the daily operation of the payroll system.		
12	Present payroll business risk considerations to the board of directors on behalf of management.		

Problems **LO 3-1** 3–44.

Gary Watson, a graduating business student at a small college, is currently interviewing for a job. Gary was invited by both Tilly Manufacturing Co. and Watson Supply Company to travel to a nearby city for an interview. Both companies have offered to pay Gary's expenses. His total expenses for the trip were \$96 for mileage on his car and \$45 for meals. As he prepares the letters requesting reimbursement, he is considering asking for the total amount of

the expenses from both employers. His rationale is that if he had taken separate trips, each employer would have had to pay that amount.

- a. Who are the parties that are directly affected by this ethical dilemma?
- b. Are the other students at the college potentially affected by Gary's decision? Explain.
- c. Are the professors at the college potentially affected by Gary's decision? Explain.
- d. What would you do in this situation?
- e. What would you do if both companies mailed you \$141 for your expenses with no action on your part?

- LO 3-4** 3-45. Roland Company, a retail store, has utilized your services as independent auditor for several years. During the current year, the company opened a new store, and in the course of your annual audit, you verify the cost of the fixtures installed in the new store by examining purchase orders, invoices, and other documents. This audit brings to light an understated invoice nearly a year old in which a clerical error by the supplier, Western Showcase, Inc., caused the total of the invoice to read \$28,893.62 when it should have read \$82,893.62. The invoice was paid immediately upon receipt without any notice of the error, and subsequent statements and correspondence from Western Showcase, Inc., showed that the account with Roland Company had been paid in full. Assume that the amount in question is material in relation to the financial position of both companies.

- a. What action should you take in this situation?
- b. If the client should decline to take any action in the matter, would you insist that the unpaid amount of \$54,000 be included in the liabilities shown on the balance sheet as a condition necessary to your issuance of an unqualified audit report?
- c. Assuming that you were later retained to make an audit of Western Showcase, Inc., would you utilize the information gained in your audit of Roland Company to initiate a reopening of the account with that company?

- LO 3-5, 7** 3-46. Thomas Gilbert and Susan Bradley formed a professional corporation called "Financial Services Inc.—A Professional Corporation," each taking 50 percent of the authorized common stock. Gilbert is a CPA and a member of the AICPA. Bradley is a CPCU (Chartered Property Casualty Underwriter). The corporation performs auditing and tax services under Gilbert's direction and insurance services under Bradley's supervision.

One of the corporation's first audit clients was Grandtime Company. Grandtime had total assets of \$600,000 and total liabilities of \$270,000. In the course of his examination, Gilbert found that Grandtime's building, with a carrying value of \$240,000, was pledged as collateral for a 10-year term note in the amount of \$200,000. The client's financial statements did not mention that the building was pledged as collateral for the 10-year term note. However, as the failure to disclose the lien did not affect either the value of the assets or the amount of the liabilities, and his examination was satisfactory in all other respects, Gilbert rendered an unmodified opinion on Grandtime's financial statements. About two months after the date of his opinion, Gilbert learned that an insurance company was planning to loan Grandtime \$150,000 in the form of a first-mortgage note on the building. Realizing that the insurance company was unaware of the existing lien on the building, Gilbert had Bradley notify the insurance company of the fact that Grandtime's building was pledged as collateral for a term note.

Shortly after the events described above, Gilbert was charged with several violations of professional ethics.

Identify and discuss at least four ethical implications of those acts by Gilbert that were in violation of the AICPA *Code of Professional Conduct*.

AICPA Code of Professional Conduct Research Problems

LO 3-5, 7

- 3-47. This problem requires access to the AICPA *Code of Professional Conduct* at pub.aicpa.org/codeofconduct.

Sandra Singer is the partner in charge of the Minneapolis office of Wellsley and Associates, CPAs. Sandra asked you to research several issues related to Aweb, a potential new audit client.

Research each of the following situations and resolve each to the extent possible. Provide the Rule of the *Code of Professional Conduct (Code)* involved as well as section numbers of the *Code* that address the issue and your resolution of the issue—you need not consider the conceptual frameworks. Briefly summarize your findings.

- a. Alvin Adams, a partner in Minneapolis owns 100 shares of Aweb stock. The investment is immaterial to Alvin and he will not work on the engagement. If Adams retains his investment, does it impair the firm's independence?
- b. Carla Clark is a manager in the Duluth office; her father works as a sales agent for Aweb. Carla will not work on the engagement. Does the *Code* allow Wellsley and Associates to audit Aweb if father and daughter retain their positions?
- c. If the firm obtains this engagement, can Sandra publicly disclose the fact that the firm audits Aweb?
- d. This potential client contacted Singer as the result of an advertisement suggesting that Wellsley and Associates audits a number of "high tech" companies, which it does. She understands that advertising is generally acceptable but realizes there are some constraints. What constraints on advertising are included in the *Code*?

LO 3-7 3-48. Use the *Code of Professional Conduct* (available at pub.aicpa.org/codeofconduct) to research each of the circumstances presented in Problem 3-40 and address whether Daleiden would violate the *Code*. Provide the Rule of the *Code of Professional Conduct* involved as well as section numbers of the *Code* that address the issue and your resolution of the issue—you need not consider the conceptual frameworks. Briefly summarize your finding, including any relevant rule references.

LO 3-7 3-49. Use the *Code of Professional Conduct* (available at pub.aicpa.org/codeofconduct) to research each of the circumstances presented in Problem 3-41 and address whether Bell & Greer's independence is impaired. Provide the section of the Independence Rule and any detailed related sections that address the issue and your resolution of the issue—you need not consider the conceptual framework. Briefly summarize your finding, including any relevant rule references.

In-Class Team Cases

LO 3-6



3-50. The issue of whether the performance of nonattest (consulting) services for audit clients impairs independence of the auditors has been widely debated within the public accounting profession. Restrictions on the performance of consulting are a major aspect of the Sarbanes-Oxley Act of 2002.

- a. Describe the restrictions that are placed on the performance of nonattest services for audit clients by the Sarbanes-Oxley Act of 2002.
- b. List arguments for restricting nonattest services for audit clients.
- c. List arguments against restricting nonattest services for audit clients.
- d. Present your opinion and support it with one or more of the arguments listed above.

LO 3-5

3-51. You are the partner-in-charge of a large metropolitan office of a regional public accounting firm. Two members of your professional staff have come to you to discuss problems that may affect the firm's independence. Neither of these situations has been specifically answered by the AICPA Professional Ethics Division. Therefore, you must reach your own conclusions as to what to advise your staff members, and what actions, if any, are to be taken by the firm.

Case 1: Don Moore, a partner in the firm, has recently moved into a condominium that he shares with his girlfriend, Joan Scott. Moore owns the condominium and pays all the expenses relating to its maintenance. Otherwise, the two are self-supporting. Scott is a stockbroker, and recently she has started acquiring shares in one of the audit clients of this office of the public accounting firm. The shares are held in Scott's name. At present, the shares are not material in relation to her net worth.

Case 2: Mary Reed, a new staff auditor with the firm, has recently separated from her husband. Mary has filed for divorce, but the divorce cannot become final for at least five months. The property settlement is being bitterly contested. Mary's husband has always resented her professional career and has just used community property to acquire one share of common stock in each of the publicly owned companies audited by the office in which Mary works.

For each case, you are to

- a. Set forth arguments indicating that the firm's independence has *not* been impaired.
- b. Set forth arguments indicating that the firm's independence *has* been impaired.
- c. Express your personal opinion. Identify those arguments from part (a) or part (b) that you found most persuasive. If you believe that the firm's independence has been impaired, make suggestions about how the problem might be resolved.

Research and Discussion Case

LO 3-4



3–52. The International Bank of Commerce (IBC) is an audit client of your public accounting firm. IBC is a multinational financial institution that operates in 23 countries. During the current year's audit, you have discovered the following problems:

- Improper loans were made to stockholders and other related parties.
- Loans were recorded on the books that appear to be either false or deceitful.

You are especially concerned about these findings because it appears that members of senior management were aware of, and participated in, these illegal activities. In accordance with professional standards, you have communicated these illegal acts to IBC's audit committee of the board of directors. However, you are not satisfied with the committee's reaction to the situation. The chair of the audit committee thanked you cordially, but the committee took no action to investigate the activities or prevent their occurrence in the future.

- a. Describe the consequences if you immediately communicated these matters directly to the SEC.
- b. Describe your appropriate course of action in this situation.
- c. Present arguments for and against requiring auditors to report illegal acts directly to regulatory agencies.

Supplementary References

AICPA *Code of Professional Conduct*, Independence Rule (Section 1.200), pub.aicpa.org/codeofconduct.

AICPA *Code of Professional Conduct*, Confidential Client Information Rule (Section 1.700), pub.aicpa.org/codeofconduct.

AICPA AU-C 250, *Illegal Acts by Clients*, PCAOB AS 2405.

Legal Liability of CPAs

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 4-1** Describe the types of CPA liability.
- LO 4-2** Distinguish between CPA liability under common law and under statutory law.
- LO 4-3** Explain the proof requirements for clients and third parties seeking recovery from CPAs under common law and the defenses available to CPAs.
- LO 4-4** Explain the proof requirements for plaintiffs under statutory law and the defenses available to the auditors.
- LO 4-5** Compare the requirements for CPA liability under the Securities Act of 1933 with those under the Securities Exchange Act of 1934.
- LO 4-6** Describe CPA legal liability for accounting and review services.

In this era of litigation, investors and creditors who suffer financial losses and experience market downturns are likely to find certified public accountants (CPAs), as well as attorneys and corporate directors, tempting targets for recovery through suits that allege professional “malpractice.” Because of this situation, CPAs should approach every engagement with the prospect that they may be required to defend their work in court. Even if the court finds in favor of the CPAs, the costs of defending a legal action can be astronomical. As a result of the number of lawsuits, the cost of defending the lawsuits, and related damages when the auditors are found to be liable, the price of professional liability insurance is high. In fact, the large accounting firms self-insure for professional liability because insurance for these firms is not available at a reasonable cost.

Costs are not the only concern in this area; lawsuits damage a professional’s reputation. In extreme cases, the CPAs may even be tried criminally for certain types of conduct or omissions during an audit. Everyone who is considering a career in public accounting should be aware of the potential legal liability inherent in the practice of accounting.

The Scope of CPA Liability

LO 4-1

Describe the types of CPA liability.

The sheer number of parties suffering significant losses due at least partially to the use of information on which CPAs have reported creates a situation in which potential liability may exceed that of other professionals such as physicians. If a physician or an attorney is negligent, the injured party is usually limited to the professional’s patient or client. If CPAs are negligent in expressing an opinion on financial statements, millions of investors as well as the company itself and company creditors may sustain losses. Amounts in excess of \$300 million have been awarded to parties as a result of litigation against public accounting firms.

Litigation Placed in Perspective

Any large public accounting firm that performs thousands of audits will, at one time or another, find that it has issued an unmodified report on financial statements that, in hindsight, appear to be misleading in some respect. In some circumstances, CPA liability may be relatively obvious. In others, it may not be obvious whether the situation is due to inadequate performance or other factors. To illustrate, consider the audit of the financial statements of a computer manufacturer and, more specifically, the allowance for estimated warranty costs included therein. The estimate made in February, when the financial statements are issued, may seriously understate the subsequent actual costs incurred if a large number of computers are returned because of a manufacturing defect. Investors who have sustained large losses may attempt to recover those losses, regardless of whether they believe the CPAs are at fault. Thus, if the cost of bringing suit against a company’s CPAs is relatively low and offers even a chance of recovery, the injured parties may initiate legal action.



Illustrative Case

Litigation

Sources at the Accountants' Coalition, a Washington lobbying group, have confirmed that during some recent years CPAs have spent approximately 20 percent of their revenues from audit and accounting services on litigation costs and settlements. A vice president of a major insurance company stated in *The Wall Street Journal* that his company is no longer willing to insure accounting firms for

liability. The company continues to insure engineers, architects, attorneys, physicians, and surgeons. "The risks aren't as great," the vice president observed. Even when a claim is litigated successfully, the costs can be high. The chair of an international public accounting firm described a lawsuit against his firm for an audit with fees of approximately \$20,000. Although the firm successfully defended itself in the case that went to trial, the cost of the firm's defense was approximately \$6 million.

CPAs must recognize occasional allegations of misconduct as a fact of life. Some of the lawsuits brought against CPAs will be frivolous—often simple attempts by **plaintiffs** to recover their losses. Others will have a basis in fact—perhaps judgmental errors were made by the CPAs during the engagement. No matter how careful CPAs are, any public accounting firm may find itself a **defendant** in litigation.

Sources of CPA Liability

LO 4-2

Distinguish between CPA liability under common law and under statutory law.

In the United States, CPAs have both **common law** liability and **statutory law** liability. Common law liability develops through case decisions generally arising due to breach of contract, negligence, and fraud. Statutory liability develops when a governmental unit (e.g., a state or the federal government) passes laws and regulations that either implicitly or explicitly impose potential liability upon CPAs.

The standards for recovery as well as individuals afforded remedies vary by source or "theory" of liability. These theories are explained briefly in the following overview and then discussed in detail in the remaining sections of the chapter.

1. **Contract.** CPAs enter into a contract with their client (ordinarily through the engagement letter) and agree to provide services. The potential for liability occurs when there is a **breach of contract** and when damages result due to a failure of one or both parties to a contract to perform in accordance with the contract's provisions.¹ A public accounting firm might be sued by the client for breach of contract, for example, if the firm has failed to perform the engagement in accordance with the engagement letter and the client has suffered resulting damages.
2. **Negligence.** Both clients and third parties sue CPAs for the **tort**² of negligence. **Negligence**, also referred to as ordinary or simple negligence, is a violation of a legal duty to exercise a degree of care that an ordinary prudent person would exercise under similar circumstances. For the CPA, negligence is failure to perform a duty in accordance with applicable standards. For practical purposes, negligence may be viewed as "failure to exercise due professional care." **Gross negligence** is the lack of even slight care, indicative of a *reckless disregard* for one's professional responsibilities. Substantial failures on the part of an auditor to comply with auditing standards might be interpreted as gross negligence. As discussed in detail later in this chapter, the question of whether third parties must prove a CPA guilty of gross negligence (rather than ordinary negligence) to recover losses revolves in part around jurisdictional differences in interpretation of the common law.

¹ Breach of contract liability is based on failure to carry out a duty created in the contract.

² Legally, a tort is a wrongful act, injury, or damage (not involving breach of contract) for which a civil action can be brought.



3. *Fraud.* Fraud is defined as misrepresentation by a person of a material fact, known by that person to be untrue or made with reckless indifference as to whether the fact is true, with the intention of deceiving the other party and with the result that the other party is injured. The Integrity and Objectivity Rule of the AICPA *Code of Professional Conduct* (discussed in Chapter 3) states that a member of the AICPA shall not knowingly misrepresent facts. The CPAs found to have violated this provision of the rule might be sued for fraud by the client or another injured party. **Constructive fraud** differs from fraud as defined above in that constructive fraud does not involve a misrepresentation with intent to deceive. Gross negligence on the part of an auditor has been interpreted by the courts as constructive fraud.
4. *Statutory liability.* CPAs have statutory liability under both the federal securities laws and state securities laws, often called “blue sky” laws. The Securities Act of 1933, which applies to initial stock offerings, imposes liability on CPAs for their audit work relating to financial statements used to register the securities for sale. The Securities Exchange Act of 1934 imposes liability on CPAs for their work on the financial statements included with a company’s ongoing reports to the Securities and Exchange Commission. The standards for liability differ under these statutes, but each provides a means for recovery against the CPAs by investors.

Sources of liability for CPAs also include criminal statutes and the Racketeer Influenced and Corrupt Organizations (RICO) Act (discussed later in the chapter).

An injured party, the plaintiff, may elect to bring suit against CPAs under common law, any applicable statute law, or both. As one might expect, plaintiffs usually select the theory or theories that have the best prospects for success. Since the federal securities acts allow class action lawsuits, in which an entire class of investors becomes the plaintiff in a single legal action, and hold CPAs auditing financial statements to very strict standards, most lawsuits against auditors by stockholders or bondholders of publicly owned corporations allege violations of these federal statutes.

CPA liability may arise from improper performance on any type of engagement—audit, other attest, tax, accounting services, or consulting services. However, CPAs are not liable to any party if they can prove that they performed their services with *due professional care* (often referred to as a “*due care defense*”). Exercising due professional care is a *complete defense* against any charge of improper conduct. However, CPAs do face the disadvantage that investors, juries, and judges view their conduct knowing the outcome of the investment and the company’s fate. Such hindsight may work against the CPAs. Often the issue comes down to the simple question of whether the CPAs should have known or seen the problems that were evolving.

CPAs’ Liability to Their Clients under Common Law

LO 4-3

Explain the proof requirements for clients and third parties seeking recovery from CPAs under common law and the defenses available to CPAs.

When CPAs take on any type of engagement, they are obliged by their contract with the client—generally the engagement letter—to exercise due professional care. This obligation exists whether or not it is specifically set forth in the contract with the client. The “client” is ordinarily the company itself,³ as contrasted to the shareholders. But the contract obligations are important because they may provide the client and third parties additional recovery rights. If the CPAs fail to perform according to the terms of the contract, the CPAs have liability to clients through the common law theory of breach of contract.

³ The client’s rights in some circumstances may be assigned to others. The *right of subrogation* allows insurers who pay the insured for a loss any right of action that the insured had. For example, if a fidelity bonding company pays the CPAs’ client for a loss due to employee theft, the fidelity bonding company would have the same recovery rights against the CPAs as did the client. Also, a bankruptcy trustee or receiver of a company that has failed will ordinarily have the client’s rights.



Illustrative Case

Liability for Nonattest Engagements

Liability for negligent performance is not limited to the area of auditing. Several large international public accounting firms have been sued by clients for allegedly performing negligent consulting services related to

the installation of sophisticated enterprise-wide computer systems for those clients. Untimely installation may be considered to be a breach of contract terms, and failure to perform adequate testing of the systems may constitute a failure to comply with professional standards.

If, however, the work is completed according to the terms of the contract, but the work has errors or falls short of professional standards, the CPAs' client would have tort action for negligence against the CPAs. In many cases, the client would have both types of recovery theories available for use against the CPAs.

Although legal differences exist between breach of contract and tort actions, in general, to establish CPA liability, a client must prove the following elements:

1. *Duty*. The CPAs accepted a duty of due professional care to exercise skill, prudence, and diligence.⁴
2. *Breach of duty*. The CPAs breached their duty of due professional care through negligent performance.
3. *Losses (damages)*. The client suffered losses.
4. *Causation (proximate cause)*. The damages were caused by the CPAs' negligent performance.

The Elements of Duty and Breach of Duty

The auditors' duty is defined by AICPA generally accepted or PCAOB auditing standards, the engagement letter, and legal considerations. In a breach of contract action, the client establishes that the CPAs' duty was breached by showing either that the auditors did not perform the obligations listed in the engagement letter or that the performance did not meet professional standards. For example, the CPAs may be sued for not performing the contractual obligations when, through no fault of the client, the audit was not completed by some agreed-upon time. Alternatively, a lawsuit arguing that the audit did not meet professional standards may be based upon the CPAs' failure to detect a fraud perpetrated by a client employee. In this second example, the key factor in determining whether the CPAs are liable is not just whether the CPAs failed to uncover fraud, but whether this failure stems from the CPAs' negligence.

Regardless of the type of engagement involved, the CPAs must perform the contract according to its terms and the performance of the work under the contract must meet applicable professional standards.

In Chapter 2, we discussed the auditors' responsibility for detecting misstatements due to **errors** and fraud. Auditors must design their audits to obtain *reasonable assurance* of detecting misstatements due to errors and fraud that are material to the financial statements. In doing so, they must exercise due care and professional skepticism in planning, performing, and evaluating the results of audit procedures.

These requirements *do not imply* that auditors were negligent whenever misstatements due to errors or fraud are later found to exist in audited financial statements. An audit has certain limitations; it does not involve a complete and detailed examination of all records and transactions. To do so would entail a prohibitive cost, which would certainly not be warranted under ordinary business conditions. There can never be absolute assurance that



⁴ This element is often relatively easy to prove because by accepting an engagement the CPAs assume a responsibility to exercise due care.



Illustrative Case

Contributory Negligence

In *Cenco, Inc. v. Seidman & Seidman* (1982), the court clarified the auditors' liability to

the corporation when prior management has been engaged in improper activities.

Several former top managers of Cenco had engaged in a massive fraudulent scheme to inflate the corporation's inventories. However, seven of nine members of the board of directors were not involved in the fraud, although there was evidence that they were negligent in allowing the fraud to go undetected.

When the fraud was discovered, the stockholders sued the corporation, its corrupt managers, and Seidman & Seidman,

the corporation's auditors. The corporation then filed a cross-complaint against Seidman, and Seidman responded with a contributory negligence defense. Seidman settled the class action suit by the stockholders before it went to the jury. In the cross-complaint by the corporation, the jury found that Seidman was not liable for breach of contract, negligence, or fraud. In upholding the decision, the U.S. Court of Appeals for the Seventh Circuit indicated it was appropriate to impute the actions of corrupt management to the corporation. Thus, the corporation was a party to the fraud and not entitled to recover losses from the auditors.

errors or fraud do not exist among the transactions not included in the CPAs' tests. Also, the possibility exists that the documents have been so skillfully forged, or some other fraud has been so expertly concealed, that the application of normal auditing techniques would not reveal the fraud. When a public accounting firm's audit *has been performed in accordance with AICPA or PCAOB auditing standards*, the firm has not breached its duty and *should not be held liable* for failure to detect the existence of errors or fraud.

The Element of Losses (Damages)

A plaintiff's losses, or damages, are dependent upon the nature of the engagement performed by the CPAs. On a financial statement audit, they may include losses by the client from embezzlement. On a tax engagement, they may include tax penalties or extra taxes paid.

The Element of Causation (Proximate Cause)

Causation exists when damage to another is directly attributable to a wrongdoer's act. Even though a public accounting firm might have been negligent in rendering services, it will not be liable for the *plaintiff's* loss if its negligence was not the cause of the loss. The auditors' primary defense to litigation brought for breach of contract or negligence is ordinarily to show that the audit was performed with due professional care and that there was no negligence in the performance of the contract and professional duties.

An additional possible defense for the auditors is that the loss is due to other causes. The auditors might be able to show that, regardless of whether negligence was involved, the negligence alleged by the client was not the **proximate cause** of the client's loss. Demonstrating the client's **contributory negligence** is one means of showing that the auditors' negligence was not the cause (or sole cause) of the client's loss. In jurisdictions (e.g., states) that follow pure contributory negligence doctrines, the auditors may entirely eliminate their liability to the client by establishing the defense of contributory negligence by the client. However, very few states follow the doctrine of pure contributory negligence.

Many states rely on the concept of **comparative negligence**. Comparative negligence permits juries to examine the issue of causation and assess a percentage figure of fault to the CPAs, any other defendants, and the client. This system permits the allocation of damages among the parties based on the extent to which each is at fault. For example, a jury might determine that the CPAs were 50 percent at fault for the losses resulting from a failure to detect an employee embezzlement scheme, that management consultants were 30 percent responsible, and that client management was 20 percent responsible. The client will be able to recover from the CPAs and the management consultants 50 percent and 30 percent, respectively, of the losses. This allocation of damages is also referred to as **proportionate liability**.

Joint and several liability represents another approach to liability that in general benefits a plaintiff's litigation against multiple defendants. Under joint and several liability, the defendants are liable for their pro rata share of any damages awarded (as is the case with proportionate liability), but they also may be held liable for damages of other defendants who prove to be unable to pay their share of the damages. Using our earlier example in which the CPAs were found to be 50 percent responsible for losses, if the management consultants did not have the ability to pay all of the losses attributed to them, the auditors as joint defendants would be required to make up the difference.

Auditors' Common Law Liability to Third Parties

Clients have recourse against auditors for damages caused by an improper audit through both breach of contract and tort actions against the auditors. But what about the many third parties who rely upon audited financial statements? How may these parties recover their losses from auditors who have performed an improper audit?

As is the case for clients, third parties must establish that losses resulted from the CPAs' performance and that the CPAs breached a duty of due professional care. In a typical case, a third party seeking damages from a public accounting firm seeks to establish that it sustained a loss caused by relying upon misleading financial statements that included an audit report that was the product of an inadequate audit. The auditors named as defendants in a common law action are in the position of having to refute the charges brought by the plaintiffs.

A plaintiff who can establish gross negligence or fraud on the part of the auditors (as well as breach of duty and losses) will be able to establish liability against the auditors. Also, in certain situations, the plaintiff need only establish ordinary negligence to establish liability against the auditors. Auditors' liability to third parties for ordinary negligence under common law varies from one jurisdiction to another, generally based on state law and its interpretation by courts within each state. Three general approaches may be used to summarize auditors' liability to third-party financial statement users under common law in the various state courts: the *Ultramares (Known User) Approach*, the *Restatement (Foreseen User) Approach*, and the *Rosenblum (Foreseeable User) Approach*.

Ultramares (Known User) Approach⁵

The most widely cited common law **precedent** stems from the landmark case *Ultramares v. Touche & Co.*, 174 N.E. 441 (N.Y. 1931). In this case, the defendant CPAs issued an unqualified opinion on the balance sheet of a company engaged in the importation and sale of rubber. On the basis of the CPAs' opinion, Ultramares made several loans to the company. Shortly thereafter, the company was declared bankrupt, and Ultramares sued the CPAs for ordinary negligence. The New York Court of Appeals (the state's highest court) ruled that the CPAs should be held liable for *ordinary negligence* only to their client and any third party (beneficiary) specifically identified as a user of the CPAs' report. The court went on to indicate that the auditors should be held liable to *unidentified* third-party users of the audit report for *gross negligence or fraud*. In the *Ultramares* case, the audit was performed "primarily for the benefit" of the client; Ultramares was not specifically identified as a user of the audit report. Therefore, to recover its losses, Ultramares would have been required to prove that the CPAs were grossly negligent in performing their audit. The case eventually was settled out of court, with no determination of whether the auditors had been grossly negligent.

The *Ultramares* precedent has been reaffirmed and interpreted in many subsequent cases. These cases have clarified the conditions necessary for parties to be considered to

⁵ This approach is referred to by numerous other titles, including the *third-party beneficiary approach*, the *primary benefit approach*, and the *privity (or near privity) approach*.

be **third-party beneficiaries** of the audit. For example, the New York Court of Appeals upheld and interpreted the *Ultramares* precedent in the case of **Credit Alliance Corp. v. Arthur Andersen & Co.**, 65 N.Y.2d 536 (1985). The court stated that before auditors may be held liable for ordinary negligence to a third party, they must have *been aware* that the financial statements were to be used for a particular purpose by a *known party or parties*, and must have taken *some action* to indicate that knowledge. Because the auditors are not technically contracted with the third party, this approach is often referred to as near **privity**.

Restatement of Torts (Foreseen User) Approach

The principle of auditor liability for ordinary negligence to third parties is expanded by the American Law Institute's (ALI's) **Second Restatement of the Law of Torts (Restatement)**. *Restatements of law* are compilations of the majority view of the common law of the states on various topics such as contracts and torts and are meant to serve as guides for judges when they are issuing opinions in which there are common law issues. The *Restatement* approach to third-party liability, also referred to as the foreseen third-party approach, expands the auditors' liability for ordinary negligence to include third parties who are foreseen users of the audited financial statements. *The specific identity of foreseen users need not be known to the CPAs.*

The courts in many states have followed the *Restatement* principle, including a court in Rhode Island in the leading case of *Rusch Factors, Inc. v. Levin*, 284 F. Supp. 85 (D.R.I. 1968). In that case, the CPAs were found liable for ordinary negligence to a third party that subsequently provided financing to the audit client. The third party had *not* been specifically identified to the CPAs, although they were aware that the financial statements were to be used to help obtain the financing. In *Williams Controls v. Parente, Randolph, Orlando & Associates*, 39 F. Supp. 2d 517 (M.D. Pa. 1999), a more recent example, the court held the auditors liable to a purchaser of a client's business even though that purchaser was not the one originally identified when the audit began. The court noted that when the audit engagement letter was signed, the auditors knew that their work would be used for purposes of completing a sale of one of the client's divisions. Who the buyer would be was irrelevant for purposes of auditor liability under the *Restatement* principle. The courts of many states follow this principle of liability to third parties.⁶

Rosenblum (Foreseeable User) Approach

This approach was based originally on the 1983 New Jersey Supreme Court case **Rosenblum v. Adler** (93 N.J. 324), which rejected the approaches arising out of *Ultramares* and the *Second Restatement of Torts* and established a very different standard. In this case, the defendant CPAs issued an unqualified report on the financial statements of Giant Stores Corporation, which showed the corporation to be profitable. In reliance upon these statements, Rosenblum sold a catalog showroom business to Giant in exchange for shares of Giant's stock. Shortly afterward, Giant filed for bankruptcy and the stock became worthless. Rosenblum sued Giant's CPAs, alleging ordinary negligence. The case was dismissed by the trial court on the premise that the CPAs were not liable to unidentified third parties for ordinary negligence. However, the New Jersey Supreme Court reversed the lower court, finding that CPAs *can be held liable for ordinary negligence* to any third party the auditors could "reasonably foresee" as recipients of the statements for routine business purposes. While the approach has the potential to increase auditor liability, few states have elected to follow it; indeed, New Jersey subsequently overturned its findings and moved towards the *Ultramares* approach.

⁶ Some courts have applied a type of modified rule in which they have limited the liability of the auditors to the intended user and not any subsequent users who are substituted, such as a second bank or another buyer. One of the reasons for this limitation to the primary intended party is that circumstances change with each departing user of the financial statements and the auditors should have the benefit of full information before liability is imposed.



Illustrative Case

Liability to Third Parties under the Restatement of the Law of Torts

Dianne Holiday, CPA, performed the audit of Lyman Corporation for the year ended December 31. Holiday was aware that Lyman intended to use the audit report to obtain a bank loan. However, no specific bank was identified to Holiday. After the report was issued, Lyman obtained loans from the First National Bank and Dime Box State Bank. Also, Wallace Manufacturing Co. relied on Holiday's opinion in providing trade credit to Lyman. If the court applied the known user principles of the *Restatement* (foreseen user)

approach, Holiday could be held liable to First National and Dime Box if she was found guilty of ordinary negligence in the performance of her audit. The banks form a limited class of third parties who could be foreseen to rely on the audit report. Wallace Manufacturing Co., on the other hand, would have to prove *gross negligence* on the part of Holiday to recover its losses. The audit was not performed for the use of trade creditors; therefore, Wallace would not be considered a part of a limited class of foreseen users.

Summary of Third-Party Liability Approaches

Common law cases are decided, in large part, by reference to established precedents—that is, past decisions. The *Ultramares* (known user), *Restatement* (foreseen user), and *Rosenblum* (foreseeable user) approaches create conflicting precedents as to which third parties can hold the auditors liable for ordinary negligence. Variants of each of these approaches exist in the various states. Figure 4.1 summarizes differences in third-party ability to recover damages for CPAs' ordinary negligence liability under the three basic approaches. It is important to remember that any third party that suffers losses caused by reliance on the auditors' representations can hold them liable for proven gross negligence and fraud.

FIGURE 4.1
Summary of Third-Party Common Law Liability for Ordinary Negligence

Approach	Requirements for a Third Party to Recover Losses Due to CPAs' Ordinary Negligence
<i>Ultramares</i> approach (known user approach)	The auditors knew that the audited financial statements were for use for a <i>particular purpose by a known user</i> (third-party beneficiary).
<i>Restatement</i> approach (foreseen user approach)	The auditors knew the audited financial statements were for use for a <i>particular purpose</i> , but the auditors <i>did not necessarily know the specific user</i> (e.g., the financial statements were known to be for use in helping to sell the business to an unidentified purchaser).
<i>Rosenblum</i> approach (foreseeable user approach)	The auditors should have realized that it was <i>reasonably foreseeable</i> that the financial statements would be used by this user.

Liability to Third Parties under Statutory Law

LO 4-4

Explain the proof requirements for plaintiffs under statutory law and the defenses available to the auditors.

Statutory law is written law, created by state or federal legislative bodies. Most states have “blue sky” laws, which regulate the issuance and trading of securities within the state. The two most important federal laws relating to auditors' liability are the **Securities Act of 1933** (the 1933 Act) and the **Securities Exchange Act of 1934** (the 1934 Act). CPAs also must be concerned with the application of the Racketeer Influenced and Corrupt Organizations Act (RICO). Even though our discussion of statutory law will be limited to these three federal acts, CPAs should be familiar with other federal laws along with the blue sky laws in those states in which their clients sell securities.

Litigation against auditors that is based on statutory provisions does not enjoy the latitude available under common law. While common law can vary from state to state

and can evolve with differing factual circumstances and changing conditions, statutorily based litigation is constrained to a greater extent by the underlying law.

Securities Act of 1933

The 1933 Act requires a company intending to offer its securities for sale to the public to first file a **registration statement**.⁷ This registration statement, filed with the SEC, includes audited financial statements and numerous other disclosures. Under the 1933 Act, both the company filing the registration statement and its auditors may be held liable to purchasers of the securities in the event that the registration statement is found to contain material misstatements or omissions.⁸ The wording of Section 11(a) of the act provides as follows:

In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may . . . sue.

Source: Section 11(a), Securities Act of 1933.

Plaintiffs' Rights under the 1933 Act

The 1933 Act offers protection to only a limited group of investors—those who initially purchase a security offered for sale under the registration statement.⁹ For those investors, however, the 1933 Act shifts much of the burden of proof from the plaintiff to the defendant. The plaintiffs (security purchasers) need only prove that (1) they sustained a loss and (2) the registration statement was misleading. They *need not prove*¹⁰ that they relied upon the registration or that the auditors were negligent.

Auditors' Defenses under the 1933 Act

If auditors are to avoid liability for the plaintiffs' losses, they generally must affirmatively prove that (1) they conducted the audit with **due diligence**, (2) the plaintiffs' losses were not caused by misstated financial statements, (3) the plaintiffs knew of the financial statement misstatement when the securities were purchased, or (4) the statute of limitations—one year after the discovery of the misstatement, but no more than three years after the security was first offered to the public—had expired.

As a practical matter, it is the due diligence defense that auditors often raise. Section 11 of the act states that the auditors are not liable if they

had, after reasonable investigation, reasonable ground to believe and did believe, at the time . . . the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact.

Source: Section 11, Securities Act of 1933.

⁷ The 1933 Act requires registration statements to be filed by any company that will offer securities for sale to the public through the mails or interstate commerce. There are certain exceptions, for example, for charitable institutions and other not-for-profit organizations, and for offerings of small dollar amounts.

⁸ The auditors are liable for misstatements or omissions only in those portions of the registration statement covered by their audit and report.

⁹ Secondary purchasers who bought securities within the first year of the registration statement also may bring suit against the company and the auditors under the Securities Act of 1933.

¹⁰ An exception exists in that Section 11 requires reliance when the plaintiff purchases the security after the issuance of an earnings statement covering a period of at least 12 months following the effective date of the registration statement.

The due diligence standard of the 1933 Act establishes a high level of auditors' responsibility for justifying their performance. Not only are auditors liable for losses caused by acts of ordinary negligence, but they must *prove their innocence* rather than merely refute the accusations of the plaintiffs. Establishing the due diligence defense has proved difficult for auditors, and the standing precedent on interpretation of due diligence is *Escott v. BarChris Construction Corporation*, 283 F. Supp. 643 (S.D.N.Y. 1968). The case was an action under Section 11 of the Securities Act of 1933 by purchasers of BarChris's registered debentures against the directors, underwriters, and independent auditors of BarChris. Subsequent to issuance of the debentures, BarChris, a builder of bowling alleys, went bankrupt. The plaintiffs claimed that the registration statement for the debentures contained materially false statements and material omissions; the defendants all countered with the due diligence defense. The court found that the registration statement (Form S-1) was false and misleading and that with a few exceptions none of the defendants had established their due diligence defense. The court also found that the public accounting firm had failed to comply with generally accepted auditing standards. The court was especially critical of the public accounting firm's conduct of the S-1 review, so called because it is an investigation carried out by the public accounting firm some time after completion of the audit, but just prior to the effective date of the registration statement filed with the SEC. In an S-1 review, the CPAs look for any evidence arising since their audit that indicates that the registration statement is misleading as filed. The court criticized the public accounting firm for performing too limited a review and for being "too easily satisfied with glib answers by management" to inquiries.

While the *BarChris* case was decided over 40 years ago, it remains the standing precedent for auditor liability. In fact, its interpretation of Section 11, in terms of the auditors' defenses, was so stringent that there are relatively few additional cases related to Section 11 liability because of defendants' unwillingness to litigate cases fully when there is such a strict standard of auditor liability.

Securities Exchange Act of 1934

While the 1933 Act requires issuers to register securities with the SEC, the Securities Exchange Act of 1934 requires all companies under SEC jurisdiction to file annual audited and quarterly reviewed financial statements with the SEC.¹¹ The act also creates potential liability for the filing company and its auditors to anyone who buys or sells the company's securities in the event that these annual statements are found to be misleading. While the 1933 Act creates liability only to those investors involved in the initial distribution of a public offering, the 1934 Act expands that liability to subsequent purchasers and sellers of the stock. The two primary liability Sections of the act are Sections 10 and 18.

Section 10, with Rule 10b-5 promulgated by the SEC under Section 10(b) of the act, reads as follows:



It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any national securities exchange . . .

- (1) to employ any device, scheme, or artifice to defraud,
- (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements . . . not misleading, or
- (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Source: Section 10(b), Securities Exchange Act of 1934.

¹¹ Companies under SEC jurisdiction include those (1) whose securities are listed on a national stock exchange or (2) with equity securities traded on the over-the-counter market, and total assets exceeding \$5 million and 500 or more stockholders.

Section 18(a) of the 1934 Act, which relates to misstated financial statements, provides for liability to [emphasis added]

any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages by such reliance, *unless the person sued shall prove that he acted in good faith* and had no knowledge that such statement was false or misleading.

Source: Section 18(a), Securities Exchange Act of 1934.

Plaintiffs' Rights under the 1934 Act

The 1934 Act offers protection to both original and subsequent purchasers and sellers of securities. Under both Section 10 and Section 18, the plaintiffs (security purchasers and sellers) must prove that (1) they sustained losses, (2) the financial statements were misleading, and (3) they relied upon the financial statements. Section 10(b) and Rule 10b-5, as interpreted by the landmark case ***Ernst & Ernst v. Hochfelder***, 425 U.S. 185 (1976), require that the plaintiffs prove **scienter** (intent to deceive, manipulate, or defraud) on the part of the auditors.

Ernst & Ernst v. Hochfelder was brought by a group of investors against the public accounting firm that for 21 years had audited the financial statements of First Securities Company of Chicago, a small brokerage firm. The president of First Securities, who was also its majority stockholder, committed suicide, leaving a note stating that the firm was insolvent and disclosing a fraud that he had perpetrated upon several investors. The president had persuaded the investors to mail him their personal checks, the funds from which he was to invest in escrow accounts yielding high returns to the investors. There were no such escrow accounts in the accounting records of First Securities Company; instead, the president was engaged in a **Ponzi scheme** in which he diverted the investors' checks to his own use immediately upon receipt.

The investors filed suit under SEC Rule 10b-5 (and the related Securities Exchange Act of 1934 Section 10[b]) against the public accounting firm, charging it with *ordinary negligence*, and thus with responsibility for the investors' losses in the fraud. The plaintiffs *did not accuse the public accounting firm of fraud or intentional misconduct*. That is, they did not attempt to prove scienter.

The basis for the plaintiffs' charge of negligence was that the public accounting firm failed to discover a weakness in First Securities Company's control that enabled the company's president to carry on the fraud. The control weakness, called the "mail rule," was the president's policy that *only he* could open mail addressed to him at First Securities, or addressed to First Securities to his attention. It is common practice at financial institutions for *all* incoming mail to be opened in the mailroom, in part to avoid the possibility of employees' perpetrating some type of fraud.

The case was ultimately resolved by the U.S. Supreme Court, which ruled that an action for damages under Section 10(b) of the 1934 Act and the related SEC Rule 10b-5 was not warranted in the absence of scienter on the auditors' part. The court held that auditors are liable under Section 10(b) only upon proof of intent to deceive, manipulate, or defraud.¹²

The **Private Securities Litigation Reform Act of 1995** was designed to limit frivolous securities lawsuits. Prior to passage of this act, plaintiffs could proceed with minimal evidence of scienter and then use pretrial discovery to seek further proof. In *Tellabs, Inc. v. Makor*, 551 U.S. 308 (2007), the Supreme Court defined the standard that the plaintiff should meet in order to proceed with a case alleging securities fraud litigation. The court concluded that a complaint must show "cogent and compelling" evidence of scienter.

¹² The Court did not rule on whether the existence of reckless behavior would be sufficient to establish scienter and thereby impose liability.

Auditors' Defenses under the 1934 Act

Under Section 18, the auditors may avoid liability by proving “good faith,” which they will normally be able to establish unless they have been guilty of gross negligence or fraud. Under Section 10, the auditors will attempt to prove that there was no scienter. That is, the auditors did not perform the audit with the intent to deceive, manipulate, or defraud. In addition, to avoid liability for the plaintiffs’ losses under either Section 10 or 18, the auditors may rely on causation—that the losses experienced by the plaintiffs were caused by factors other than the auditors’ behavior.

Proportionate Liability under the 1934 Act

Historically, defendants in actions under the 1934 Act were jointly and severally liable for all the plaintiffs’ losses. However, the Private Securities Litigation Reform Act of 1995 amended the 1934 Act to place limits on the amount of the auditors’ liability. In general, the amendment establishes proportionate liability. If one or more of the defendants are not able to pay their share of the losses, the auditors will have unlimited joint and several liability only to certain small investors. To other investors, the auditors’ liability for losses caused by other parties is limited to an amount not to exceed 50 percent of the auditors’ proportionate share of the losses. If the auditors were knowingly involved in violations of the law, complete joint and several liability may be imposed.

In addition to the 1995 reforms, Congress passed the Securities Litigation Uniform Standards Act in 1998 to establish uniform standards for bringing class action securities suits in both state and federal courts. Under these standards, plaintiffs and their lawyers must follow certain certification procedures and there are consolidation rules with regard to the trial of these cases.

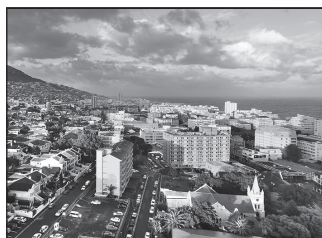
Comparison of the 1933 and 1934 Acts

LO 4-5

Compare the requirements for CPA liability under the Securities Act of 1933 with those under the Securities Exchange Act of 1934.

The 1933 and 1934 Acts differ in investors protected and the burden of proof required. The 1933 Act offers recourse only to individuals acquiring the initial distribution of securities, whereas the 1934 Act offers recourse to *any* person buying or selling the securities at a later date.

In comparison to common law, both of the federal securities acts shift significant burdens of proof from the plaintiffs to the defendants. However, some differences exist between the defendant’s burden under the 1933 Act and the 1934 Act. Under the 1933 Act, plaintiffs *need not prove reliance* upon the audited financial statements. The 1934 Act, however, generally requires plaintiffs to prove that they relied upon the misleading statements.



Illustrative Case

Proportionate vs. Joint and Several Liability



Assume that \$50 million of damages is awarded to a plaintiff and the auditors’ percentage of responsibility is established at 10 percent. The following summarizes three possible liability approaches:

Strictly proportionate liability: The auditors’ share will be \$5 million ($10\% \times \$50$ million).

Proportionate liability as per the 1934 Act: Liability is the strictly proportionate liability amount of \$5 million plus, if some defendants are unable to pay their share:

1. Joint and several liability to small investors with a net worth of less than \$200,000 and recoverable damages that exceed 10 percent of their net worth and
2. Additional liability to other investors of a maximum of 50 percent of the proportionate share; in this situation, an additional \$2,500,000 ($50\% \times \$5,000,000$).

Thus, the maximum auditor liability is \$7,500,000 plus (1).

Joint and proportionate liability: If some other defendants are unable to pay their share, the auditors’ share increases proportionately. In the extreme, if no other defendants are able to pay any amount, the auditors are liable for the entire \$50 million.

FIGURE 4.2 Summary of Auditor Civil Liability under the 1933 Securities Act (Section 11) and the 1934 Securities Exchange Act (Sections 10 and 18)

Act	What Must Be Proved by the Third Party?			Basic Standard of Liability
	A Loss?	Misleading Financial Statements?	Reliance on Financial Statements?	
1933 Securities Act—Section 11	Yes	Yes	No	Auditor must prove due diligence
1934 Securities Exchange Act—Section 10	Yes	Yes	Yes	Third party must prove existence of scienter (auditors' intent to deceive, manipulate, or defraud)
1934 Securities Exchange Act—Section 18	Yes	Yes	Yes	Auditor must prove good faith

Next, both acts place the burden of proving adequate performance on the defendants. The 1933 Act requires the auditors to prove “due diligence”; if they were ordinarily negligent, they will not be able to establish this defense. The 1934 Act is more lenient in that Section 10 requires the existence of scienter, while Section 18 requires auditors to prove that they acted in good faith. Because it requires the existence of gross negligence or fraud, the “good faith” defense is considerably easier to establish than is “due diligence.” Figure 4.2 summarizes important similarities and differences between the two acts.

Racketeer Influenced and Corrupt Organizations Act

In 1970, Congress enacted the Racketeer Influenced and Corrupt Organizations Act (RICO) as a weapon against mobsters and racketeers who were influencing legitimate business. A discussion of RICO would appear to be out of place in a discussion of legal liability of auditors. However, the act broadly defines the term *racketeering activities* to include crimes such as mail fraud and fraud in the sale of securities. Prior to 1993, these provisions were used successfully in a small number of cases against CPAs in which it could be shown that the CPAs knew, or perhaps should have known, of material misstatements of financial statements when the problems were indicative of a pattern of improper activity. A primary concern with the RICO Act is the provision that allows triple damages in civil cases brought under the act.

In 1993, a favorable ruling by the U.S. Supreme Court, in the case of *Reves v. Ernst & Young*, 507 U.S. 170 (1993), relieved much of the concern about auditors' liability under the RICO Act. The Court decided that the accountants cannot be held liable under the RICO Act unless they actually participated in the operation or management of the organization. Subsequently, the Private Securities Litigation Reform Act of 1995 eliminated securities fraud as an offense in a civil RICO action unless there is a prior conviction. However, a number of states continue to have their own versions of RICO.

Auditors' Criminal Liability under the Securities Acts

Both the Securities Act of 1933 and the Securities Exchange Act of 1934 include provisions for *criminal charges* against CPAs who willfully (knowingly) allow misstatements in SEC filings, as do other statutes. Most directly relevant are Section 24 of the Securities Act of 1933, Section 1106 of the Sarbanes-Oxley Act, and Section 32(a) of the Securities Exchange Act of 1934. In addition, in extreme cases, CPAs can be prosecuted under the criminal provisions of RICO, where it can be shown that the CPAs actually participated in the management or operation of a company that is indicted under RICO.

The *Continental Vending Machine Corporation* case was accompanied by a celebrated criminal case involving three members of the public accounting firm that audited Continental's financial statements. The criminal charges rocked the profession because the CPAs were convicted of criminal fraud on the basis of gross negligence.

The verdict of guilty was affirmed by a U.S. Court of Appeals, and the U.S. Supreme Court refused to review the case. The three CPAs were later pardoned by the president of the United States.

In the *Continental Vending* case (*United States v. Simon*, 425 F.2d 796 [2d Cir. 1969]), the U.S. government brought charges of fraud against three CPAs. The charges hinged upon a note to Continental's audited financial statements, which read:

The amount receivable from Valley Commercial Corp. (an affiliated company of which . . . [Continental's president] is an officer, director, and stockholder) bears interest at 12 percent a year. Such amount, less the balance of the notes payable to that company, is secured by the assignment to the Company of Valley's equity in certain marketable securities. As of . . . [the date of the auditors' report] . . . the amount of such equity at current market quotations exceeded the net amount receivable.

Source: *United States v. Simon*, 425 F.2d 796, 800 (2d Cir. 1969).

The note did not disclose—and the auditors were aware—that the affiliated company had loaned approximately that same amount to Continental's president. The president was unable to repay the affiliate, which was unable to repay Continental. In addition, most of the collateral furnished by the president was stock and convertible debentures of Continental itself.

The auditors' defense in this case was that the note complied with existing generally accepted accounting principles. Eight "leaders of the profession" testified as expert witnesses that the note was consistent with generally accepted accounting principles and the audit was performed in accordance with generally accepted auditing standards. However, the judge rejected this argument and instructed the jury to evaluate whether the financial statements were "fairly presented" without reference to generally accepted accounting principles. The finding by the jury that the balance sheet did not present fairly Continental's financial position led to conviction of the three CPAs.

Because the *Continental Vending* case involved both criminal and civil proceedings, it has significant implications for the public accounting profession. Not only is civil liability an ever-present hazard for CPAs, but criminal charges also may be involved.

Criminal Liability under Other Statutes

In addition to the securities laws, CPAs and public accounting firms may be subject to prosecution under a host of other criminal statutes. This fact became all too apparent to the profession when, in June 2002, Arthur Andersen became the first major accounting firm ever convicted of a felony. The indictment, which named only the firm and not any employees or partners, accused Arthur Andersen of the "wholesale destruction of documents" relating to the Enron Corporation collapse. Representatives of Arthur Andersen stated that the firm was merely applying its document retention policy in destroying the documents. While prosecutors emphasized the great volume of documents destroyed, the jury, in finding Arthur Andersen guilty, based its verdict primarily on an e-mail message written by an Arthur Andersen attorney. In that e-mail message, the attorney advised an Arthur Andersen partner to revise a memo to omit certain information, including a comment that an Enron press release included an earnings announcement that was misleading. Arthur Andersen representatives acknowledged that the conviction effectively put the firm out of business. The case is particularly relevant to the profession in that it illustrates how the actions of a relatively small number of employees can lead to disastrous results for the firm. Ultimately, the conviction was overturned by the U.S. Supreme Court based on the fact that the jury was given inappropriate instructions.

SEC and Public Company Accounting Oversight Board Regulation

The SEC has issued rules for the appearance and practice of CPAs, attorneys, and others before the commission under the statutes it administers. SEC Rule of Practice 102(e),

actions under which are often referred to as “102(e)” or “2e” proceedings, gives the SEC the power of suspension and disbarment, and has the following wording:

The Commission may censure a person or deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission . . . (1) not to possess the requisite qualifications to represent others, or (2) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct.

Source: SEC Rule of Practice 102(e).

On occasion, the SEC has taken punitive action against public accounting firms when it has found the audit work deficient with regard to financial statements filed with the commission. These actions against public accounting firms usually arise when a listed corporation encounters financial difficulties and it later appears that misleading financial statements had served to conceal for a time the losses being incurred by the company. In recent years, the SEC has taken action against public accounting firms by the use of consent decrees in which the CPAs have agreed to certain penalties or restrictions. For example, a public accounting firm may settle charges brought by the SEC through a consent decree in which it agrees not to accept new SEC clients during a specified period and to permit a review of its practice.

The Private Securities Litigation Reform Act of 1995 (discussed earlier in this chapter) requires auditors to play a more active disclosure role with respect to their clients. Under these changes to the 1934 Act, auditors who discover illegal acts by a client are required to report them to the board of directors of their clients, and, in some cases, to the SEC (e.g., when the client has not taken appropriate remedial action). Auditors are relieved of any SEC sanctions if they timely report required information about clients to the SEC. The failure to take the necessary statutory steps for disclosure and reporting can result in additional liability for the auditor, including the possibility that such failure rises to the level of fraud or collusion with the client.

As discussed in Chapter 2, the Public Company Accounting Oversight Board, created by the Sarbanes-Oxley Act of 2002, also may conduct investigations and disciplinary proceedings on both registered public accounting firms and professional employees (including owners). Board sanctions may include monetary damages, suspension of firms and accountants from working on engagements for publicly traded companies, and referral of criminal cases to the Justice Department.

CPAs' Liability for Accounting and Review Services

LO 4-6

Describe CPA legal liability for accounting and review services.

Up to this point, we have emphasized the liability of public accounting firms when they are associated with audited financial statements. In addition, CPAs are subject to legal liability when they perform accounting services, such as write-up work and *compilations* of unaudited financial statements. These services differ from audits in that the CPAs neither perform the verification procedures involved in an audit nor issue an auditors' opinion as to the fairness of the financial information.

The term **compilation of financial statements** refers to an accounting service performed by CPAs with the objective of assisting management in presenting financial information in the form of financial statements *without obtaining or providing any assurance on those statements*. Compilation and **review of financial statements** are described in Chapter 19.

Do CPAs associated with unaudited financial statements have any potential legal liability? The answer is *yes*. The CPAs, acting as *accountants* rather than as *auditors*, still have a liability to their client to exercise due professional care. In addition, they still may be liable for losses to third parties.

When CPAs are associated with unaudited financial statements, a possibility exists that the client or third parties may misinterpret the extent of their services and believe that the accountants are acting as auditors. The risks to public accounting firms engaged

in the preparation of unaudited financial statements were brought sharply into focus by the *1136 Tenants' Corporation v. Rothenberg*, 36 A.D.2d 804 (N.Y. 1971) case. In this case, an incorporated apartment cooperative, which was owned by its shareholder-tenants and managed by a separate realty agent, orally retained a public accounting firm for a period of 17 months to perform certain services, including the preparation of financial statements for the cooperative. The public accounting firm's fee was to be only \$600 per year.

The public accounting firm submitted financial statements of the corporation for one full year and the first six months of the following year. The financial statements bore the notation "subject to comments in letter of transmittal." The referenced letter of transmittal read in part:

Pursuant to our engagement, we have reviewed and summarized the statements of your managing agent and other data submitted to us by . . . [the agent], pertaining to 1136 Tenants' Corporation. . . .

The following statements were prepared from the books and records of the Corporation. No independent verifications were undertaken thereon.

Source: SEC Rule of Practice 102(e).

The client corporation later sued the public accounting firm for damages totaling \$174,000 for the CPAs' alleged failure to discover defalcations of the corporation's funds committed by the managing agent. The client contended that the CPAs had been retained to render all necessary accounting and *auditing* services for it. The CPAs maintained they had been engaged to do write-up work only, although a working paper they had prepared supporting accrued expenses payable in the balance sheet included an entry for "audit expense."

The New York state trial court ruled in favor of the plaintiff on a decision affirmed by the Appellate Court of New York. The latter found that the CPAs' working papers indicated that the CPAs had examined the client's bank statements, invoices, and bills, and had made notations in their working papers concerning "missing invoices."

In summary, the court held the CPAs liable because it found that they had led their client to believe that they were performing an audit. Consequently, the courts held the CPAs responsible for performing their work in accordance with generally accepted auditing standards, which they clearly had not done. More important, however, the court also concluded that the CPAs had a duty to follow up on significant problems (the missing invoices) uncovered during their engagement. Thus, it is probable that the public accounting firm would have been held liable to its client *even if the court had recognized that the firm was not performing an audit*. Whenever CPAs encounter evidence that their client may be sustaining a loss through embezzlement or other fraud, they should warn the client immediately.

There are several lessons for public accounting firms in the *1136 Tenants' Corporation* case:

1. CPAs who prepare unaudited financial statements should adhere closely to the AICPA *Code of Professional Conduct*. The Integrity and Objectivity Rule states that a CPA shall not knowingly misrepresent facts, and the Compliance with Standards Rule requires a public accounting firm to comply with professional standards, including standards for accounting and review services. The actions of the public accounting firm described in the preceding paragraph might be construed as violating both rules.
2. **Engagement letters** are as essential for accounting and review services as they are for independent audits. Oral arrangements for accounting and review services are of scant assistance when there is a dispute as to the nature of the services to be rendered by the public accounting firm to the client.

3. The CPAs engaged to perform *accounting or review* services should be alert for, and follow up on, such unusual items as missing invoices. As professionals, CPAs are bound to exercise *due professional care*, even when their engagements do not include independent audits of the client's financial statements.
4. CPAs should report on financial statements clearly and concisely, using, to the extent possible, the standardized language set forth in the appropriate standards. Reports should indicate the nature of the services rendered and the degree of responsibility being assumed by the public accounting firm.

CPAs' Posture in the Age of Litigation

In addition to the preceding court cases, numerous other actions against CPAs, under both common law and the 1933 and 1934 Securities Acts, are pending trial. It is apparent that lawsuits will continue to plague the public accounting profession, as they have the legal and medical professions. The question thus is: What should be CPAs' reaction to this age of litigation?

In the opinion of the authors, positive actions helpful to CPAs in withstanding threats of possible lawsuits include the following:

1. Greater emphasis upon compliance with the public accounting profession's auditing standards and ethical requirements. Close analysis of the court cases and other actions described in this chapter discloses numerous instances in which the auditors appear not to have complied fully with one or more of the auditing and ethical standards.
2. Retaining legal counsel that is familiar with CPAs' legal liability. The CPAs should thoroughly discuss all potentially dangerous situations with their legal counsel and should carefully consider their counsel's advice.
3. Maintenance of adequate liability insurance coverage. Although liability insurance coverage should not be considered a substitute for the CPAs' compliance with the preceding recommendations, public accountants must protect themselves against possible financial losses from lawsuits. Adequate liability insurance is essential.
4. Thorough investigation of prospective clients. As indicated in preceding sections of this chapter, many court cases involving CPAs have been accompanied by criminal charges against top management of the CPAs' clients. CPAs should use great care in screening prospective clients to avoid the risks involved in professional relationships with those who lack integrity.
5. Obtaining a thorough knowledge of the client's business. One of the major causes of audit failures has been a lack of understanding by auditors of the client's business, industry practices, and accounting framework.
6. Use of engagement letters for all professional services. Controversies over what services were performed by the CPAs can be minimized by a clearly written contract describing the agreed-upon services. CPAs also may insert various types of clauses to limit liability in engagement letters. For example, a clause may be included in the letter that indemnifies and holds harmless the CPAs from all liability and costs resulting from knowing misrepresentations by management. Engagement letters are discussed in Chapter 6.
7. In planning engagements, carefully assess the risk of errors and fraud in the client's financial statements. The CPAs should exercise special care when the client has material weaknesses in internal control.
8. Exercising extreme care in audits of clients in financial difficulties or with a high degree of business risk. Creditors and shareholders of companies that are insolvent or in bankruptcy are likely to seek recovery of their losses. As the court cases described in this chapter demonstrate, litigation involving CPAs tends to center around the auditing of clients who later become bankrupt. Other litigation-sensitive audit engagements include rapid-growth entities, entities that have recently completed or are contemplating initial public offerings, and entities with material-related party transactions.
9. Making certain that working papers have been professionally and completely assembled. Chapter 5 provides details on working paper preparation and assembly.

Chapter Summary

This chapter described the legal environment of auditors, emphasizing legal liability under both common law and statutory law. To summarize:

1. Under common law, CPAs are liable to their clients for failure to exercise due professional care. Accordingly, ordinary negligence is a sufficient degree of misconduct to hold CPAs liable for damages caused to their clients.
2. Auditors' liability to third parties under common law varies from state to state. One way to summarize these differences is to consider three general approaches: (a) *Ultramares* (known user) approach, (b) *Restatement* (foreseen user) approach, and (c) *Rosenblum* (foreseeable user) approach. Under the *Ultramares* (known user) approach, CPAs are held liable for ordinary negligence only to parties known to be the primary users of the financial statements. Other third parties must prove gross negligence on the part of the auditors. Under the *Restatement* (foreseen user) approach, liability for ordinary negligence to third parties is extended to include any limited class of parties that could be foreseen to rely upon the financial statements. The *Rosenblum* (foreseeable user) approach extends the auditors' liability for ordinary negligence even further to include any third party the auditors could reasonably foresee as recipients of the financial statements.
3. Auditors may also be held liable to third parties under the federal securities laws, which allow class action lawsuits by purchasers or sellers of a company's securities. The Securities Act of 1933 is unique in that most of the burden of proof in litigation is shifted to the auditors, with the primary defenses available to the auditor consisting of (a) knowledge of the plaintiffs of the errors or omissions or (b) due diligence by the auditors. Due diligence is a difficult defense to establish.
4. CPAs are also subject to criminal prosecution for violation of various statutes, including criminal fraud in which their conduct was intentional or involved collusion with the client.
5. To protect themselves from the liability crisis of today, auditors strive to adhere to a high level of professional performance. They also attempt to avoid engagements that have a very high risk of litigation.

Key Terms Introduced or Emphasized in Chapter 4

Breach of contract (131) Failure of one or both parties to a contract to perform in accordance with the contract's provisions. A public accounting firm might be sued for breach of contract, for example, if the firm failed to perform the engagement in accordance with the engagement letter. Negligence on the part of the CPAs also constitutes breach of contract.

Common law (131) Unwritten law that has developed through court decisions; it represents judicial interpretation of a society's concept of fairness. For example, the right to sue a person for fraud is a common law right.

Comparative negligence (134) A concept used by certain courts to allocate damages between negligent parties based on the degree to which each party is at fault. The allocation of damages is referred to as *proportionate liability*.

Compilation of financial statements (144) An accounting service performed by CPAs with the objective of assisting management in presenting financial information in the form of financial statements *without obtaining or providing any assurance on those statements*.

Constructive fraud (132) Performing duties with such recklessness that persons believing the duties to have been completed carefully are being misled. It differs from fraud in that constructive fraud does not involve knowledge of misrepresentations within the financial statements.

Contributory negligence (134) Negligence on the part of the plaintiff that has contributed to his or her having incurred a loss. Contributory negligence may be used as a defense because the court may limit or bar recovery by a plaintiff whose own negligence contributed to the loss.

Credit Alliance Corp. v. Arthur Andersen & Co. (136) A common law decision by the New York Court of Appeals (New York's highest court) stating that auditors must demonstrate knowledge of reliance on the financial statements by a third party for a particular purpose to be held liable for ordinary negligence to that party. Basically, this case upheld the *Ultramares v. Touche & Co.* rule.

Defendant (131) The party against which damages and suit are brought by the plaintiff.

Due diligence (138) A public accounting firm's contention that its audit work was adequate to support its opinion on financial statements included in a registration statement filed with the SEC under the Securities Act of 1933.

Engagement letter (145) A written contract summarizing the contractual relationship between the CPAs and the client. The engagement letter typically specifies the scope of professional services to be rendered, expected completion dates, and the basis for determination of the CPAs' fee. Engagement letters are discussed more fully in Chapter 6.

Ernst & Ernst v. Hochfelder (140) A landmark case in which the U.S. Supreme Court decided that auditors could not be held liable under the Securities Exchange Act of 1934 for ordinary negligence.

Error (133) An unintentional misstatement of financial statements or omission of an amount or a disclosure.

Fraud (132) Misrepresentation by a person of a material fact, known by that person to be untrue or made with reckless indifference as to whether the fact is true, with intent to deceive and with the result that another party is injured.

Gross negligence (131) Lack of even slight care, indicative of a reckless disregard for one's professional responsibilities. Substantial failures on the part of an auditor to comply with auditing standards might be interpreted as gross negligence.

Joint and several liability (135) A legal concept that holds a class of defendants jointly responsible for losses attributed to the class as well as liable for any share of losses that cannot be collected from those unable to pay their share. Thus, a financially responsible defendant may be required to pay losses attributed to defendants that do not have the ability to pay.

Negligence (131) Violation of a legal duty to exercise a degree of care that an ordinarily prudent person would exercise under similar circumstances. Also referred to as ordinary or simple negligence.

Plaintiff (131) The party claiming damages and bringing suit against the defendant.

Ponzi scheme (140) A swindle in which a quick return on an initial investment is paid out of funds of new investors to lure the victims into bigger risks. This is named for Charles Ponzi, who in 1919 convinced people he could make them a 50 percent profit in 45 days by an international trading scam. Old investors were paid off with cash from new investors. Ultimately such schemes collapse and the newest investors lose their investment because there is no actual appreciation of assets involved.

Precedent (135) A legal principle that evolves from a common law court decision and then serves as a standard for future decisions in similar cases.

Private Securities Litigation Reform Act of 1995 (140) A law passed to limit the ability of plaintiffs to file frivolous class action law suits under the federal securities acts. It increased the burden of proof of fraud to file a suit and limited the application of joint and several liability.

Privity (136) The relationship between parties to a contract. A CPA firm is in privity with the client which it is serving. This legal doctrine that a contract confers rights and imposes liabilities only on the contracting parties.

Proportionate liability (134) A method of allocating damages to each group that is liable according to that group's pro rata share of any damages recovered by the plaintiff. For example, if the plaintiff was awarded a total of \$1,000,000 and the CPAs were found to bear 40 percent of the responsibility for the damages, the CPAs would be assessed \$400,000.

Proximate cause (134) Damage to another is directly attributable to a wrongdoer's act. The issue of proximate cause may be raised as a defense in litigation. Even though a public accounting firm might have been negligent in rendering services, it will not be liable for the plaintiff's loss if its negligence was not the proximate cause of the loss.

Registration statement (138) A document including audited financial statements that must be filed with the SEC by any company in order to sell its securities to the public through the mails or interstate commerce. The Securities Act of 1933 provides liability to security purchasers for material misrepresentations in registration statements.

Review of financial statements (144) The performance of limited investigative procedures that are substantially less in scope than an audit made in accordance with generally accepted auditing standards. The procedures provide the CPAs with a basis to provide *limited assurance* that the financial statements are in accordance with generally accepted accounting principles.

Rosenblum v. Adler (136) A common law decision by the New Jersey Supreme Court that holds CPAs liable for acts of ordinary negligence to "reasonably foreseeable third parties" not in privity of contract. Conflicts with the precedents established in both the *Ultramares* and the *Restatement of Law of Torts* approaches to liability.

Scienter (140) Intent to deceive, manipulate, or defraud. The U.S. Supreme Court held in the *Hochfelder* case that scienter must be proved for the auditors to be held liable under the Securities Exchange Act of 1934. This term is also explicitly included (with a similar definition) in a number of common law actions. Generally, gross negligence or reckless behavior on the part of the auditors is sufficient to establish scienter.

Second Restatement of the Law of Torts (136) A summary of tort liability, which, when applied to auditor common law liability, expands auditors' liability for ordinary negligence to include third parties of a limited class of known or intended users of the audited financial statements. Conflicts with the precedents established by the *Ultramares* and the *Rosenblum* approaches to liability.

Securities Act of 1933 (137) A federal securities statute covering registration statements for securities to be sold to the public. The act requires auditors to exercise "due diligence" and creates both civil and criminal penalties for misrepresentation.

Securities Exchange Act of 1934 (137) A federal securities statute requiring public companies to file annual audited financial statements with the SEC. The act requires auditors to "act in good faith" and creates civil and criminal penalties for misrepresentation.

Statutory law (131) Written law created by state or federal legislative bodies. CPAs must concern themselves particularly with the federal securities acts and state blue sky laws. These laws regulate the issuance and trading of securities.

Third-party beneficiary (136) A person, not the auditors or their client, who is named in a contract (or known to the contracting parties) with the intention that such person should have definite rights and benefits under the contract.

Tort (131) A civil wrong. For financial statements audits, the primary tort involved is that of performing the engagement negligently.

Ultramares v. Touche & Co. (135) A common law decision by the New York Court of Appeals (New York's highest court) stating that auditors are liable to third parties not in privity of contract for acts of fraud or gross negligence, but not for ordinary negligence. Conflicts with precedents established by the *Restatement of Torts* and *Rosenblum* approaches to liability.

Review Questions

- 4-1. Explain why the potential liability of auditors for professional "malpractice" exceeds that of physicians or other professionals.
- 4-2. Distinguish between ordinary negligence and gross negligence within the context of the CPAs' work.
- 4-3. What is meant by the term *privity*? How does privity affect the auditor's liability under common law?
- 4-4. Define the term *third-party beneficiary*.
- 4-5. Distinguish between common law and statutory law.
- 4-6. Briefly describe the differences in liability to third parties under the known user, foreseen user, and foreseeable user approaches to CPA liability.
- 4-7. Briefly describe the different common law precedents set by the *Ultramares v. Touche & Co.* case and the *Rosenblum v. Adler* case.
- 4-8. What landmark case was embraced by the court in the case of *Credit Alliance Corp. v. Arthur Andersen & Co.*? Identify the two factors that the court stated must be proved for the auditors to be held liable for ordinary negligence to a third party.
- 4-9. Compare auditors' common law liability to clients and third-party beneficiaries with their common law liability to other third parties.
- 4-10. Contrast *joint and several liability* with *proportionate liability*.
- 4-11. Compare the rights of plaintiffs under common law with the rights of persons who purchase securities registered under the Securities Act of 1933 and sustain losses. In your answer, emphasize the issue of who must bear the burden of proof.
- 4-12. State briefly a major distinction between the Securities Act of 1933 and the Securities Exchange Act of 1934 with respect to the type of transactions regulated.
- 4-13. Why was the *Ernst & Ernst v. Hochfelder* decision considered a "victory" for the accounting profession?
- 4-14. How was the *Continental Vending* case unusual with respect to penalties levied against auditors?

- 4-15. Why did Congress enact the Racketeer Influenced and Corrupt Organizations Act? Why has it been of concern to auditors? What subsequent developments have reduced this concern?
- 4-16. How does the SEC regulate auditors who appear and practice before the commission?
- 4-17. In the *1136 Tenants' Corporation* case, what was the essential difference in the way the client and the CPAs viewed the work to be done in the engagement?
- 4-18. Comment on the following statement: While engagement letters are useful for audit engagements, they are not necessary for compilation and review engagements.
- 4-19. Rogers and Green, CPAs, admit they failed substantially to follow generally accepted auditing standards in their audit of Martin Corporation. "We were overworked and understaffed and never should have accepted the engagement," said Rogers. Does this situation constitute fraud on the part of the public accounting firm? Explain.

Questions Requiring Analysis

- LO 4-3 4-20. Glover, Inc., engaged Herd & Irwin, CPAs, to assist in the installation of a new computerized production system. Because the firm did not have experienced staff available for the engagement, Herd & Irwin assigned several newly hired staff assistants without sufficient supervision. As a result, Glover, Inc., incurred significant losses when the production system crashed, causing significant backlogs and lost product sales.
Describe the possible legal implications of this situation for Herd & Irwin.
- LO 4-3 4-21. Jensen, Inc., filed suit against a public accounting firm, alleging that the auditors' negligence was responsible for failure to disclose a large defalcation that had been in process for several years. The public accounting firm responded that it may have been negligent, but that Jensen, Inc., was really to blame because it had completely ignored the public accounting firm's repeated recommendations for improvements in internal control.
If the public accounting firm was negligent, is it responsible for the loss sustained by the client? Does the failure by Jensen, Inc., to follow the auditors' recommendation for better internal control have any bearing on the question of liability? Explain.
- LO 4-3 4-22. The public accounting firm of Hanson and Brown was expanding very rapidly. Consequently, it hired several staff assistants, including James Small. Subsequently, the partners of the firm became dissatisfied with Small's production and warned him that they would be forced to discharge him unless his output increased significantly.
At that time, Small was engaged in audits of several clients. He decided that, to avoid being fired, he would reduce or omit entirely some of the required auditing procedures listed in the audit plan prepared by the partners. One of the public accounting firm's non-SEC clients, Newell Corporation, was in serious financial difficulty and had adjusted several of its accounts being examined by Small to appear financially sound. Small prepared fictitious working papers in his home at night to support purported completion of auditing procedures assigned to him, although he in fact did not examine the Newell adjusting entries. The public accounting firm rendered an unqualified opinion on Newell's financial statements, which were grossly misstated. Several creditors, relying upon the audited financial statements, subsequently extended large sums of money to Newell Corporation.
Would the public accounting firm be liable to the creditors who extended the money in reliance on the erroneous financial statements if Newell Corporation should fail to pay its creditors? Explain.
- LO 4-3 4-23. Wanda Young, doing business as Wanda Young Fashions, engaged the CPA partnership of Scott & Green to audit her financial statements. During the audit, Scott & Green discovered certain irregularities that would have indicated to a reasonably prudent auditor that James Smith, the chief accountant, might be engaged in a fraud. However, Scott & Green, not having been engaged to discover defalcations, submitted an unqualified opinion in its report and did not mention the potential defalcation problem.
What are the legal implications of the above facts as they relate to the relationship between Scott & Green and Wanda Young? Explain.
- LO 4-3 4-24. Susan Harris is a new assistant auditor with the public accounting firm of Sparks, Watts, and Wilcox, CPAs. On her third audit assignment, Harris examined the documentation underlying 60 disbursements as a test of controls over purchasing, receiving, vouchers payable, and cash disbursement procedures. In the process, she found five disbursements for the purchase of materials with no receiving reports in the documentation. She noted the exceptions in her working papers and called them to the attention of the senior auditor. Relying on prior experience with the client, the senior auditor disregarded Harris's comments, and nothing further was done about the exceptions.

Subsequently, it was learned that one of the client's purchasing agents and a member of its accounting department were engaged in a fraudulent scheme whereby they diverted the receipt of materials to a public warehouse while sending the invoices to the client. When the client discovered the fraud, the conspirators had obtained approximately \$700,000—\$500,000 of which was obtained after the completion of the audit.

Discuss the legal implications and liabilities to Sparks, Watts, and Wilcox as a result of the above facts.

(AICPA, adapted)

- LO 4-4, 5** 4-25. Sawyer and Sawyer, CPAs, audited the financial statements of Rattler Corporation that were included in Rattler's Form 10-K, which was filed with the SEC. Subsequently, Rattler Corporation went bankrupt and the stockholders of the corporation brought a class-action lawsuit against management, Sawyer and Sawyer, and the corporation's board of directors and attorneys for misstatements of the financial statements.

Assume that the jury in the case decides that responsibility for \$5 million in losses should be allocated as follows:

Management	70%
Board of directors	20
Auditors	5
Attorneys	5
	<u>100%</u>

- Under what securities act would the stockholders initiate this lawsuit?
- Assuming that all the defendants in the case are financially able to pay their share of the losses, calculate the amount of losses that would be allocated to Sawyer and Sawyer.
- Assuming that management had no financial resources, describe how Sawyer and Sawyer's share of the losses might be increased.

- LO 4-3, 4, 5** 4-26. The international CPA firm of Arthur Andersen faced significant liability in conjunction with its audits of Enron Corporation.

- From a legal liability perspective, describe the unique features of this audit case.
- Describe the important implications of this audit case for a firm of public accountants.

- LO 4-4** 4-27. Gordon & Moore, CPAs, were the auditors of Fox & Company, a brokerage firm. Gordon & Moore examined and reported on the financial statements of Fox, which were filed with the Securities and Exchange Commission.

Several of Fox's customers were swindled by a fraudulent scheme perpetrated by two key officers of the company. The facts establish that Gordon & Moore were negligent, but not reckless or grossly negligent, in the conduct of the audit, and neither participated in the fraudulent scheme or knew of its existence.

The customers are suing Gordon & Moore under the antifraud provisions of Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 for aiding and abetting the fraudulent scheme of the officers. The customers' suit for fraud is predicated exclusively on the negligence of the auditors in failing to conduct a proper audit, thereby failing to discover the fraudulent scheme.

Answer the following, setting forth reasons for any conclusions stated.

- What is the probable outcome of the lawsuit? Explain.
- What other theory of liability might the customers have asserted?

(AICPA, adapted)

Objective Questions

Select questions are available with *Connect*.[®]



LO 4-3

4-28. Multiple Choice Questions

Select the best answer for each of the following questions and explain the reasons for your choice.

- If a CPA performs an audit recklessly, the CPA will be liable to third parties who were unknown and not foreseeable to the CPA for:
 - (1) Strict liability for all damages incurred.
 - (2) Gross negligence.
 - (3) Either ordinary or gross negligence.
 - (4) Breach of contract.

LO 4-3

b. Which of the following approaches to auditors' liability is least desirable from the CPA's perspective?

- (1) The *Ultramares* approach.
- (2) The *Rosenblum* approach.
- (3) The *Restatement of Torts* approach.
- (4) The Foreseen User approach.

LO 4-3

c. In cases of breach of contract, plaintiffs generally have to prove all of the following, except:

- (1) The CPAs had a duty.
- (2) The CPAs made a false statement.
- (3) The client incurred losses related to the CPAs' performance.
- (4) The CPAs breached their duty.

LO 4-2, 3

d. If the CPAs provided negligent tax advice to a public company, the client would bring suit under:

- (1) The Securities Act of 1933.
- (2) The Securities Exchange Act of 1934.
- (3) The federal income tax law.
- (4) Common law.

LO 4-3

e. Which of the following cases reaffirmed the principles in the *Ultramares* case?

- (1) *Credit Alliance Corp. v. Arthur Andersen & Co.*
- (2) *Rosenblum v. Adler.*
- (3) *Ernst & Ernst v. Hochfelder.*
- (4) *Escott v. BarChris Construction Corporation.*

LO 4-3

f. Under common law, the CPAs who were negligent may mitigate some damages to a client by proving:

- (1) Contributory negligence.
- (2) The CPAs' fee was not material.
- (3) The CPAs were not competent to accept the engagement.
- (4) The CPAs' negligence was caused by the fact that they had too much work.

LO 4-4

g. Under the Securities and Exchange Act of 1934, auditors and other defendants are generally faced with:

- (1) Joint liability.
- (2) Joint and several liability.
- (3) Proportionate liability.
- (4) Limited liability.

LO 4-4

h. A CPA issued an unqualified opinion on the financial statements of a company that sold common stock in a public offering subject to the Securities Act of 1933. Based on a misstatement in the financial statements, the CPA is being sued by an investor who purchased shares of this public offering. Which of the following represents a viable defense?

- (1) The investor has *not* proved fraud or negligence by the CPA.
- (2) The investor did *not* actually rely upon the false statement.
- (3) The CPA detected the false statement after the audit date.
- (4) The false statement is immaterial in the overall context of the financial statements.

LO 4-3

i. Which of the following elements is most frequently necessary to hold a CPA liable to a client?

- (1) Acted with scienter or guilty knowledge.
- (2) Was not independent of the client.
- (3) Failed to exercise due care.
- (4) Did not use an engagement letter.

LO 4-4

j. Which statement best expresses the factors that purchasers of securities registered under the Securities Act of 1933 need to prove to recover losses from the auditors?

- (1) The purchasers of securities must prove ordinary negligence by the auditors and reliance on the audited financial statements.

- (2) The purchasers of securities must prove that the financial statements were misleading and that they relied on them to purchase the securities.
- (3) The purchasers of securities must prove that the financial statements were misleading; then, the burden of proof is shifted to the auditors to show that the audit was performed with “due diligence.”
- (4) The purchasers of securities must prove that the financial statements were misleading and the auditors were negligent.

LO 4-4

- k. The most significant result of the *Continental Vending* case was that it:
 - (1) Created a more general awareness of the possibility of auditor criminal prosecution.
 - (2) Extended the auditor’s responsibility to all information included in registration statements.
 - (3) Defined the CPA’s responsibilities for unaudited financial statements.
 - (4) Established a precedent for auditors being held liable to third parties under common law for ordinary negligence.

LO 4-6

- l. The *1136 Tenants’* case was important because of its emphasis upon the legal liability of the CPA when associated with:
 - (1) A review of annual statements.
 - (2) Unaudited financial statements.
 - (3) An audit resulting in a disclaimer of opinion.
 - (4) Letters for underwriters.

(AICPA, adapted)

LO 4-4, 5

- 4–29. Dandy Container Corporation engaged the accounting firm of Adams and Adams to audit financial statements to be used in connection with an interstate public offering of securities. The audit was completed, and an unqualified opinion was expressed on the financial statements that were submitted to the Securities and Exchange Commission along with the registration statement. Two hundred thousand shares of Dandy Container common stock were offered to the public at \$11 a share. Eight months later the stock fell to \$2 a share when it was disclosed that several large loans to two “paper” corporations owned by one of the directors were worthless. The loans were secured by the stock of the borrowing corporations, which was owned by the director. These facts were not disclosed in the financial statements. The director involved and the two corporations are insolvent.
State whether each of the following statements is true or false relating to original purchasers of the stock, and explain why.
 - a. The Securities Act of 1933 applies to the above-described public offering of securities.
 - b. The accounting firm has potential liability to any person who acquired the stock.
 - c. An insider who had knowledge of all the facts regarding the loans to the two paper corporations could nevertheless recover from the accounting firm.
 - d. In court, investors who bought shares in Dandy Container need only show that they sustained a loss and that failure to explain the nature of the loans in question constituted a false statement or misleading omission in the financial statements.
 - e. The accountants could avoid liability if they could show they were not negligent.
 - f. The accountants could avoid or reduce the damages asserted against them if they could establish that the drop in the stock’s market price was due in whole or in part to other causes.
 - g. The Securities and Exchange Commission would defend any action brought against the accountants in that the SEC examined and approved the registration statement.
- 4–30. Assume that in a particular audit the CPAs were negligent but not grossly negligent. Indicate whether they would be “liable” or “not liable” for the following losses proximately caused by their negligence and determine that liability under the various theories discussed and followed by different states:
 - a. Loss sustained by client; suit brought under common law.
 - b. Loss sustained by trade creditor, not in privity of contract; suit brought in a state court that adheres to the *Ultramares v. Touche Co.* precedent.
 - c. Loss sustained by a bank known to the auditors to be relying on the financial statements for a loan; suit brought in a state court that adheres to the *Credit Alliance v. Arthur Andersen* precedent.

- d. Losses to stockholders purchasing shares at an initial public offering; suit brought under the Securities Act of 1933.
- e. Loss sustained by a bank named as a third-party beneficiary in the engagement letter; suit brought under common law.
- f. Loss sustained by a lender not in privity of contract; suit brought in a state court that adheres to the *Rosenblum v. Adler* precedent.
- g. Losses sustained by stockholders; suit brought under Sections 18(a) and 10(b) of the Securities Exchange Act of 1934.

LO 4-2, 3, 4, 5 4-31. Match the important cases listed below with the appropriate legal precedent or implication.

- a. *Ernst & Ernst v. Hochfelder*
- b. *Escott v. BarChris Construction Corp.*
- c. *Credit Alliance v. Arthur Andersen & Co.*
- d. *Ultramares v. Touche & Co.*
- e. *Rosenblum v. Adler*
- f. *Rusch Factors, Inc. v. Levin*
- g. *United States v. Simon (Continental Vending)*

Legal precedent or implication:

- 1. A landmark case establishing that auditors should be held liable to third parties not in privity of contract for gross negligence, but not for ordinary negligence.
- 2. A case in which the court used the guidance of the *Second Restatement of the Law of Torts* to decide the auditors' liability to third parties under common law.
- 3. A landmark case in which the auditors were held liable under Section 11 of the Securities Act of 1933.
- 4. A case in which auditors were held liable for criminal negligence.
- 5. A case that established that auditors should not be held liable under the Securities Exchange Act of 1934 unless there was intent to deceive.
- 6. A case that established the precedent that auditors should be held liable under common law for ordinary negligence to all foreseeable third parties.
- 7. A common law case in which the court held that auditors should be held liable for ordinary negligence only to third parties they know will use the financial statements for a particular purpose.

LO 4-4, 5 4-32. Items (a) through (f) relate to what a plaintiff who purchased securities must prove in a civil liability suit against a CPA. For each item, determine whether it must be proved assuming application of the following acts:

- 1. Only applies to Section 11 of the 1933 Securities Act.
- 2. Only applies to Section 10(b) of the Securities Exchange Act.
- 3. Applies to both acts.
- 4. Applies to neither of the acts.

The plaintiff security purchaser must prove:

- a. Material misstatements were included in a filed document.
- b. A monetary loss occurred.
- c. Lack of due diligence by the CPA.
- d. Privity with the CPA.
- e. Reliance on the document.
- f. The CPA had scienter.

(AICPA, adapted)

LO 4-1, 2, 3, 4, 5 4-33. For each definition (or portion of a definition) in the first column, select the term that most closely applies. Each term may be used only once or not at all.

Partial (or Complete) Definition	Term
a. A federal securities statute covering registration statements for securities to be sold to the public.	1. Breach of contract
b. A method of allocating damages to each group that is liable according to that group's pro-rata share of any damages recovered by the plaintiff. For example, if the plaintiff was awarded a total of \$500,000 and the CPAs were found to bear 30 percent of the responsibility for the damages, the CPAs would be assessed \$150,000.	2. Common law
c. Damage to another is directly attributable to a wrongdoer's act. This issue may be raised as a defense in litigation—that is, the defense may argue that some other factor caused the loss.	3. Constructive fraud
d. Failure of one or both parties to a contract to perform in accordance with the contract's provisions.	4. Defendant
e. Intent to deceive, manipulate, or defraud. This concept is used in the 1934 Securities Exchange Act to establish auditor liability.	5. Fraud
f. Misrepresentation by a person of a material fact, known by that person to be untrue or made with reckless indifference as to whether the fact is true, with intent to deceive and with the result that another party is injured.	6. Joint and several liability
g. Performing duties with such recklessness that persons believing the duties to have been completed carefully are being misled. The person performing the duties does not have knowledge of misrepresentations within the financial statements.	7. Negligence
h. Unwritten law that has developed through court decisions; it represents judicial interpretation of a society's concept of fairness.	8. Ponzi scheme
i. Violation of a legal duty to exercise a degree of care that an ordinarily prudent person would exercise under similar circumstances.	9. Proportionate liability
j. Written law created by state or federal legislative bodies.	10. Proximate cause
	11. Scienter
	12. Securities Act of 1933
	13. Securities Exchange Act of 1934
	14. Statutory law

Problems

LO 4-4, 5

- 4-34. Risk Capital Limited, a publicly held Delaware corporation, was considering the purchase of a substantial amount of the treasury stock held by Florida Sunshine Corporation, a closely held corporation. Initial discussions with the Florida Sunshine Corporation began late in 20X0.

Wilson and Wyatt, CPAs, Florida Sunshine's public accountants, regularly prepared quarterly and annual unaudited financial statements. The most recently prepared unaudited financial statements were for the fiscal year ended September 30, 20X0.

On November 15, 20X0, after protracted negotiations, Risk Capital agreed to purchase 100,000 shares of no-par Class A treasury stock of Florida Sunshine at \$12.50 per share. However, Risk Capital insisted upon audited statements for the calendar year 20X0. The contract specifically provided: "Risk Capital shall have the right to rescind the purchase of said stock if the audited financial statements of Florida Sunshine for calendar year 20X0 show a material adverse change in the financial position of the Corporation."

At the request of Florida Sunshine, Wilson and Wyatt audited the company's financial statements for the year ended December 31, 20X0. The December 31, 20X0, audited financial statements furnished to Florida Sunshine by Wilson and Wyatt showed no material adverse change from the September 30, 20X0, unaudited statements. Risk Capital relied upon the audited statements and purchased the treasury stock of Florida Sunshine. It was subsequently discovered that, as of the balance sheet date, the audited statements contained several misstatements and that in fact there had been a material adverse change in the financial position of the corporation. Florida Sunshine has become insolvent, and Risk Capital will lose virtually its entire investment.

Risk Capital seeks recovery against Wilson and Wyatt.

- Discuss each of the theories of liability that Risk Capital will probably assert as its basis for recovery.
- Assuming that only ordinary negligence by Wilson and Wyatt is proved, will Risk Capital prevail? State yes or no and explain.

- LO 4-3** 4-35. Meglow Corporation, a closely held manufacturer of dresses and blouses, sought a loan from Busch Factors. Busch had previously extended \$50,000 credit to Meglow but refused to lend any additional money without obtaining copies of Meglow's audited financial statements.

Meglow contacted the public accounting firm of Seavers & Dean to perform the audit. In arranging for the audit, Meglow clearly indicated that its purpose was to satisfy Busch Factors as to the corporation's sound financial condition and to obtain an additional loan of \$100,000. Seavers & Dean accepted the engagement, performed the audit in a negligent manner, and rendered an unqualified opinion. If an adequate audit had been performed, the financial statements would have been found to be misleading.

Meglow submitted the audited financial statements to Busch Factors and obtained an additional loan of \$70,000. Busch refused to lend more than that amount. After several other factors also refused, Meglow finally was able to persuade Maxwell Department Stores, one of its customers, to lend the additional \$30,000. Maxwell relied upon the financial statements audited by Seavers & Dean.

Meglow is now in bankruptcy, and Busch seeks to collect from Seavers & Dean the \$120,000 it loaned Meglow. Maxwell seeks to recover from Seavers & Dean the \$30,000 it loaned Meglow.

- a. Will Busch recover? Explain.
- b. Will Maxwell recover? Explain.

- LO 4-2, 3, 4, 5** 4-36. After Commuter Airlines was forced into bankruptcy, the company's stockholders brought suit against Thomas & Ross, the company's independent auditors. Three independent assumptions concerning this litigation are listed below:

- a. Commuter Airlines is not under SEC jurisdiction. The plaintiff's suit is brought under common law in a state court that adheres to the *Ultramares* doctrine of auditors' liability.
- b. Commuter Airlines had recently issued its publicly held securities. The stockholders' suit is brought in federal court under the Securities Act of 1933.
- c. Commuter Airlines is under SEC jurisdiction. The stockholders' suit is brought in federal court alleging violations of Sections 18(a) and 10(b) of the Securities Exchange Act of 1934.

Under each of the independent assumptions, separately explain (1) the allegations that must be proved in court by the plaintiffs and (2) any defenses for which the auditors must bear the burden of proof if they are to avoid or reduce their liability.

- LO 4-6** 4-37. Charles Worthington, the founding and senior partner of a successful and respected public accounting firm, was a highly competent practitioner who always emphasized high professional standards. One of the policies of the firm was that all reports by members or staff be submitted to Worthington for review.

Recently, Robert Craft, a junior partner in the firm, received a phone call from Herbert Flack, a close personal friend. Flack informed Craft that he, his family, and some friends were planning to create a corporation to engage in various land development ventures; that various members of the family are presently in a partnership (Flack Ventures), which holds some land and other assets; and that the partnership would contribute all its assets to the new corporation and the corporation would assume the liabilities of the partnership.

Flack asked Craft to prepare a balance sheet of the partnership that he could show to members of his family, who were in the partnership, and to friends, to determine whether they might have an interest in joining in the formation and financing of the new corporation. Flack said he had the partnership general ledger in front of him and proceeded to read to Craft the names of the accounts and their balances at the end of the latest month. Craft took the notes he made during the telephone conversation with Flack, classified and organized the data into a conventional balance sheet, and had his secretary type the balance sheet and an accompanying letter on firm stationery. He did not consult Worthington on this matter or submit this work to him for review.

The transmittal letter stated: "We have reviewed the books and records of Flack Ventures, a partnership, and have prepared the attached balance sheet at March 31, 20X0. We did not perform an audit in conformity with generally accepted auditing standards, and therefore do not express an opinion on the accompanying balance sheet." The balance sheet was prominently marked "unaudited." Craft signed the letter and instructed his secretary to send it to Flack.

What legal problems are suggested by these facts? Explain.

- LO 4-6** 4-38. The limitations on professional responsibilities of CPAs when they are associated with unaudited financial statements are often misunderstood. These misunderstandings can be reduced substantially if CPAs carefully follow professional pronouncements in the course of their work and take other appropriate measures.

The following list describes four situations CPAs may encounter in their association with and preparation of unaudited financial statements. Briefly discuss the extent of the CPAs' responsibilities and, if appropriate, the actions to be taken to minimize misunderstandings. Identify your answers to correspond with the letters in the following list.

- a. A CPA was engaged by telephone to perform accounting work, including the compilation of financial statements. His client believes that the CPA has been engaged to audit the financial statements and examine the records accordingly.
- b. A group of business executives who own a farm managed by an independent agent engage Linda Lopez, a CPA, to compile quarterly unaudited financial statements for them. Ms. Lopez compiles the financial statements from information given to her by the independent agent. Subsequently, the business executives find the statements were inaccurate because their independent agent was embezzling funds. The executives refuse to pay Ms. Lopez's fee and blame her for allowing the situation to go undetected, contending that she should not have relied on representations from the independent agent.
- c. In comparing the trial balance with the general ledger, a CPA finds an account labeled "Audit Fees" in which the client has accumulated the CPA's quarterly billings for accounting services, including the compilation of quarterly unaudited financial statements.
- d. To determine appropriate account classification, John Day, CPA, reviewed a number of the client's invoices. He noted in his working papers that some invoices were missing but did nothing further because he thought they did not affect the unaudited financial statements he was compiling. When the client subsequently discovered that invoices were missing, he contended that the CPA should not have ignored the missing invoices when compiling the financial statements and had a responsibility to at least inform him that they were missing.

- LO 4-3** 4-39. Mark Williams, CPA, was engaged by Jackson Financial Development Company to audit the financial statements of Apex Construction Company, a small closely held corporation. Williams was told when he was engaged that Jackson Financial needed reliable financial statements that would be used to determine whether to purchase a substantial amount of Apex Construction's convertible debentures at the price asked by the estate of one of Apex's former directors.

Williams performed his audit in a negligent manner. As a result of his negligence, he failed to discover substantial defalcations by Carl Brown, the Apex controller. Jackson Financial purchased the debentures, but it would not have done so if the defalcations had been discovered. After discovery of the fraud, Jackson Financial promptly sold them for the highest price offered in the market at a \$70,000 loss.

- a. What liability does Williams have to Jackson Financial? Explain.
- b. If Apex Construction also sues Williams for negligence, what are the probable legal defenses Williams's attorney would raise? Explain.
- c. Will the negligence of Mark Williams, CPA, prevent him from recovering on a liability insurance policy covering the practice of his profession? Explain.

- LO 4-3** 4-40. Cragmore & Company, a medium-sized partnership of CPAs, was engaged by Marlowe Manufacturing, Inc., a closely held corporation, to audit its financial statements for the year ended December 31, 20X3.

Before preparing the audit report, William Cragmore, a partner, and Joan Willmore, a staff senior, reviewed the disclosures necessary in the notes to the financial statements. One note involved the terms, costs, and obligations of a lease between Marlowe and Acme Leasing Company.

Willmore suggested that the note disclose the following: "Acme Leasing Company is owned by persons who have a 35 percent interest in the capital stock and who are officers of Marlowe Manufacturing, Inc."

On Cragmore's recommendation, this was revised by substituting "minority shareholders" for "persons who have a 35 percent interest in the capital stock and who are officers."

The audit report and financial statements were forwarded to Marlowe Manufacturing for review. The officer-shareholders of Marlowe who also owned Acme Leasing objected to the revised wording and insisted that the note be changed to describe the relationship between Acme and Marlowe as merely one of affiliation. Cragmore acceded to this request.

The audit report was issued on this basis with an unqualified opinion. But the working papers included the drafts that showed the changes in the wording of the note.

Subsequent to delivery of the audit report, Marlowe suffered a substantial uninsured fire loss and was forced into bankruptcy. The failure of Marlowe to carry any fire insurance coverage was not noted in the financial statements.

What legal problems for Cragmore & Company are suggested by these facts? Discuss. (AICPA, adapted)

In-Class Team Case

LO 4-2, 3,
4, 5



- 4-41. The following appeared in a brief article in a major business newspaper: A local court is in the process of ruling on whether the public accounting firm of James Willis and Co., CPAs, PC, should be required to pay all or part of \$16 million in damages relating to Geiger Co. for failing to detect a scheme to defraud the company, a former audit client.

Geiger Co., an SEC registrant, charges that Willis was negligent in failing to discover fraud committed by the company's controller and wants Willis to foot the bill for all \$16 million in claims by and against the company. The company claims that if it had known about the fraud, it could have stopped it and recovered financially. The bank involved claims that it granted the loan based on misstated financial statements. The shareholders involved claim that they purchased the stock on the American Stock Exchange at an inflated price due to the misstated financial statements. They acknowledged that while stock had been outstanding and traded for many years (10) prior to the fraud, they made their investment decisions relying upon the misstated financial statements.

Willis's general counsel said, "We anxiously await a decision that will show that CPAs are not guarantors for everything that goes on in the company." Geiger Co.'s lawyer said that she anxiously awaited a decision because it will "clearly show that CPAs are liable for finding fraud."

Assume that Willis performed that audit with ordinary negligence and this ordinary negligence is the reason that the defalcation was not discovered and recovered. Further, assume that the \$16,000,000 of loss is properly allocated as follows:

Company itself	\$8,000,000
Bank that gave a commercial loan	5,000,000
Shareholders	3,000,000

Reply from the perspective that the only issues involved here are whether the plaintiffs involved may recover from a CPA that has performed the engagement with this degree of negligence. Assume the situation described above, and assume that other elements of proof (e.g., loss, proximate cause) are not at issue.

- a. Assume that the case is brought under common law, and that the state in which Geiger Co. is headquartered follows the *known user* approach for third-party legal liability.
 1. Should Willis be found liable to the company, Geiger Co., itself? Explain.
 2. Should Willis be found liable if sued by a bank that used the financial statements as a basis for providing a loan and, due to the misstatement, lost \$5 million on the loan? Explain.
 3. Should Willis be found liable if sued by shareholders who invested in the stock of the company? Assume these investors invested relying upon the misstated financial statements and as a result thereof lost \$3 million. Explain.
 4. Which of answers 1, 2, and 3 might change if the jurisdiction involved followed the *Restatement of Torts* approach? Explain.
- b. Assume that the case is brought under the Securities Act of 1933. Answer the following from the perspective of CPA liability under that act.
 1. Should Willis be found liable to the company, Geiger Co., itself? Explain.
 2. Should Willis be found liable if sued by a bank that used the financial statements as a basis for providing a loan and, due to the misstatement, lost \$5 million on the loan? Explain.
 3. Should Willis be found liable if sued by shareholders who invested in the stock of the company? Assume these investors invested relying upon the misstated financial statements and as a result thereof lost \$3 million. Explain.

4. Which, if any, of answers 1, 2, and 3 might change if the stock involved had been issued to the public for the first time and the financial statements involved had been included in a registration statement for the securities? Explain.
- c. Assume that the case is brought under the Securities Exchange Act of 1934. Answer the following from the perspective of CPA liability under that act.
 1. Should Willis be found liable to the company, Geiger Co., itself? Explain.
 2. Should Willis be found liable if sued by a bank that used the financial statements as a basis for providing a loan and, due to the misstatement, lost \$5 million on the loan? Explain.
 3. Should Willis be found liable if sued by shareholders who invested in the stock of the company? Assume these investors invested relying upon the misstated financial statements and as a result thereof lost \$3 million. Explain.

Research and Discussion Case



- 4-42. You are a partner in the Denver office of a national public accounting firm. During the audit of Mountain Resources, you learn that this audit client is negotiating to sell some of its unproved oil and gas properties to SuperFund, a large investment company. SuperFund is an audit client of your New York office.

Mountain Resources acquired these properties several years ago at a cost of \$15 million. The company drilled several exploratory wells but found no developable resources. Last year, you and Mountain Resources agreed that the value of these unproved properties had been “impaired” as defined in *Accounting Standards Codification*, Section 932-360-35-11. The company wrote the carrying value of the properties down to an estimated realizable value of \$9 million and recognized a \$6 million loss. You concurred with this treatment and issued an unqualified auditors’ report on the company’s financial statements.

You are now amazed to learn that the sales price for these properties being discussed by Mountain Resources and SuperFund is \$42 million. You cannot understand why SuperFund would pay such a high price and you wonder what representations Mountain Resources may have made to SuperFund concerning these properties. The management of Mountain Resources declines to discuss the details of the negotiations with you, calling them “quite delicate” and correctly pointing out that the future sale of these properties will not affect the financial statements currently under audit.

- a. Summarize the arguments for advising SuperFund (through your New York office) that you consider the properties grossly overpriced at \$42 million.
- b. Summarize the arguments for remaining silent and not offering any advice to SuperFund on this matter.
- c. Express your personal opinion as to the course of action you should take. Indicate which arguments from part (a) or part (b) most influenced your decision.

Supplementary References

AICPA *Code of Professional Conduct*, Client Confidential Information Rule (Section 1.700), pub. aicpa.org/codeofconduct

AICPA, “Consideration of Fraud in a Financial Statement Audit” (AICPA AU-C 240; PCAOB AS 2401).

AICPA, “Consideration of Laws and Regulations in an Audit of Financial Statements” (AICPA AU-C 250; PCAOB AS 2405).

FASB *Accounting Standards Codification*, Section 932-360-35-11, “Extraction Activities—Oil and Gas.”

Audit Evidence and Documentation

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 5-1** Explain the relationships among audit risk, audit evidence, and financial statement assertions.
- LO 5-2** Identify and explain the components of audit risk.
- LO 5-3** Distinguish between the concepts of *sufficient* and *appropriate* as they apply to audit evidence.
- LO 5-4** List and describe types of audit procedures.
- LO 5-5** Discuss the nature of data analytics and big data used in businesses and how they are used in auditing.
- LO 5-6** Describe the considerations involved in auditing subjective areas, such as certain financial statement items presented at fair value and related party transactions.
- LO 5-7** Describe the nature and purposes of audit documentation.

In performing financial statement audits, the auditors evaluate information to be used as **audit evidence** to obtain reasonable assurance on whether the financial statements follow the appropriate criteria, usually generally accepted accounting principles. Reasonable assurance is obtained when the auditors have obtained sufficient appropriate audit evidence to reduce audit risk (the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level.

The Relationships among Audit Risk, Audit Evidence, and Financial Statement Assertions

LO 5-1

Explain the relationship among audit risk, audit evidence, and financial statement assertions.

As discussed in Chapter 2, the term **audit risk** refers to the possibility that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. For example, it is the risk that the auditors will issue an unmodified (unqualified) opinion on financial statements that contain a material departure from generally accepted accounting principles.

Audit risk for an account or an assertion is at an appropriately low level when the auditors have obtained **sufficient appropriate** audit evidence. That is, they have an adequate quantity (sufficient) of relevant and reliable (appropriate) audit evidence to reduce audit risk to an appropriately low level.

When auditors do not have a sufficient appropriate level of audit evidence, an obvious solution is to increase the extent of the audit procedures—that is, obtain more evidence. However, another approach that is often possible is to perform more effective audit procedures. For example, in many circumstances, externally generated evidence may be considered particularly reliable and may be obtained instead of or in addition to internally generated evidence. Also, performing procedures closer to (or after) the balance sheet date rather than at an earlier date may provide more reliable audit evidence. We discuss sufficient appropriate audit evidence in greater detail later in this section.

Financial Statement Assertions

Management is responsible for the fair presentation of financial statements in conformity with generally accepted accounting principles. One way to view this responsibility is that management is responsible for presenting financial statements that have proper *amounts in the various accounts*, including properly recorded *transactions*, and properly presented *disclosures* (e.g., the notes to the financial statements). Management's responsibility may be viewed as implicitly or explicitly making appropriate **assertions** about the account balances, classes of transactions, and disclosures.¹ These assertions are summarized in Figure 5.1, which is taken from AICPA AU-C 315. The auditors may use those assertions (or others that address the aspects included in them) when considering the different types of potential misstatements that may occur involving accounts, transactions, and disclosures, as well as to assist in determining needed audit evidence.

FIGURE 5.1 AICPA Auditing Standards Board Financial Statement Assertions

Assertions About Account Balances and Related Disclosures at Period End	Assertions About Classes of Transactions and Events and Related Disclosures
<i>Existence.</i> Assets, liabilities, and equity interests exist.	<i>Occurrence.</i> Transactions and events that have been recorded or disclosed have occurred, and such transactions and events pertain to the entity.
<i>Rights and obligations.</i> The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	
<i>Completeness.</i> All assets, liabilities, and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.	<i>Completeness.</i> All transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
<i>Accuracy, valuation, and allocation.</i> Assets, liabilities, and equity interests have been included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.	<i>Accuracy.</i> Amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described. <i>Cutoff.</i> Transactions and events have been recorded in the correct accounting period.
<i>Classification.</i> Assets, liabilities, and equity interests have been recorded in the proper accounts.	<i>Classification.</i> Transactions and events have been recorded in the proper accounts.
<i>Presentation.</i> Assets, liabilities, and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.	<i>Presentation.</i> Transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

The PCAOB (AS 1105) uses an alternate approach of condensing the assertions into one set. Consistent with that approach, in this text we combine the assertions presented in Figure 5.1 as follows:

1. *Existence and occurrence.* Assets, liabilities, and equity interests exist and recorded transactions and events have occurred.
2. *Rights and obligations.* The company holds rights to the assets, and liabilities are the obligations of the company.
3. *Completeness.* All assets, liabilities, equity interests, and transactions that should have been recorded have been recorded.
4. *Cutoff.* Transactions and events have been recorded in the correct accounting period. For example, sales are recorded on the date title passes.²
5. *Accuracy, valuation, and allocation.* All transactions, assets, liabilities, and equity interests are included in the financial statements at proper amounts. This includes the (a) accuracy of the initial recording of transactions and (b) subsequent valuation and allocation (account balances). The initial recording is often at a transaction price

¹ The AICPA's Auditing Standards Board generally uses the term "classes of transactions, account balances, and disclosures" to indicate the types of potential misstatements, while the PCAOB uses "accounts and disclosures." Because many misstatements relate directly to account balances (composed of transactions and various other adjustments), we will often reverse the order and use the term "account balances, classes of transactions, and disclosures" or, more briefly, "accounts, transactions, and disclosures."

² Some, including the PCAOB, eliminate cutoff and include a proper cutoff as a part of existence/ occurrence and completeness.

(e.g., purchase or sales price). Subsequently, valuation and allocation are dictated by GAAP (e.g., lower of cost or market for inventory).

6. *Presentation and disclosure.* The components of the financial statements are properly classified, described, and disclosed.

In designing audit procedures, the auditors may use the assertions in Figure 5.1, or a condensed set such as the above, provided that the condensed set includes all financial statement aspects required by generally accepted accounting principles.

All assertions are not of equal importance to all financial statement account balances, classes of transactions, and disclosures. A **relevant assertion** is one that, without regard to the effect of controls, has a **reasonable possibility** (more than a remote likelihood) of containing a material misstatement. To illustrate relevant assertions, consider the assertions related to the cash account. The existence and completeness assertions are often relevant assertions for a material cash account since they address whether the cash actually exists and all cash has been included. However, valuation is not relevant since its value is obvious, unless currency translation is involved. When one or more relevant assertions exist, the financial statement item is referred to as a **significant account balance, class of transactions, or disclosure**.

Finally, the risk associated with a relevant assertion with a *very high* likelihood of misstatement and a very high magnitude of potential misstatement is referred to as a **significant risk**. Using the terminology of the AICPA, such a risk is “close to the upper end of the **spectrum of inherent risk**.” Significant risks and the spectrum of inherent risk are discussed in detail in Chapter 6.

Audit Risk, Misstatements, and Financial Statement Assertions

Recall that, as we indicated earlier, audit risk in essence is the risk that the auditors will issue an unmodified (unqualified) opinion on financial statements that are materially misstated. It consists of two parts: the **risks of material misstatement** in the financial statements and the *risk that the auditors will not detect such misstatement* (as discussed later in this section, referred to as detection risk). In considering the first part of audit risk (i.e., the risks of material misstatement), it is important to recognize that the professional standards require consideration of risks at two levels: (1) the financial statement level and (2) the assertion level for account balances, classes of transactions, and disclosures.

Risks of Material Misstatement at the Financial Statement Level

The risks of material misstatement at the financial statement level relate pervasively to the financial statements as a whole and potentially affect many assertions (for example, risks related to possible management override of controls potentially may affect many accounts and assertions). At the financial statement level, the auditors assess overall financial statement effects as well as likely individual assertions involved with the various types of accounts, classes of transactions, and disclosures.

The auditors’ identification and assessment of these risks is influenced by factors such as industry and business characteristics of the client, their knowledge of the client’s system of internal control, and additional information developed in prior audits. These characteristics may affect the assertions about a number of financial statement accounts. Business characteristics such as the following may be indicative of a high risk of material misstatement at the financial statement level:

- Inconsistent profitability of the client relative to other firms in the industry.
- Operating results that are highly sensitive to economic factors.
- Going concern problems.
- Large misstatements in a variety of areas detected in prior audits.
- Substantial turnover, questionable reputation, or inadequate accounting skills of management.

Because these factors increase the overall risk of the audit, their consideration is important for designing sufficient appropriate audit procedures, as well as the more basic issue of whether to accept the engagement.

Risks of Material Misstatement at the Assertion Level

LO 5-2

Identify and explain the components of audit risk.

As is the situation for risks at the financial statement level, risks of material misstatement at the assertion level³ are assessed in order to determine appropriate auditor responses in terms of the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence.

Risks of material misstatement at the assertion level are considered as consisting of two components: **inherent risk** and **control risk**. Inherent risk is the possibility of material misstatement of a financial statement assertion before considering any related controls—it varies based on the nature of the account. Inherent risk varies based on the nature of the account.

Assume that in a given business the balance of the Inventory account amounts to only one-fifth that of the Property, Plant, and Equipment account. Does this relationship indicate that the auditors should spend only one-fifth as much time in the audit of inventory as they spend in the audit of property, plant, and equipment? The answer to this question is no. Inventory is much more susceptible to error or theft than are property, plant, and equipment, and the high number of inventory transactions affords an opportunity for misstatements to be well hidden. Inherent risk also varies by the assertion being considered about a particular account. As an example, valuation of assets is often a more difficult assertion to audit than is existence of the assets. In general, assertions with high inherent risk involve

- Difficult-to-audit transactions or balances.
- Complex calculations.
- Difficult accounting issues.
- Significant judgment by management.
- Valuations that vary significantly based on economic factors.

In assessing inherent risk, it is often useful to segregate transactions into three types: routine, nonroutine, and estimation. **Routine transactions** involve recurring financial statement activities recorded in the accounting records in the normal course of business. Examples of routine transactions are sales, purchases, cash disbursements, cash receipts, and payroll transactions. The routine nature of these transactions may limit inherent risk, although controls certainly must be implemented to assure proper recording.

Nonroutine transactions involve activities that occur only periodically, such as the taking of physical inventories, calculating depreciation expense, and adjusting financial statements for foreign currency gains and losses. Inherent risk may be high for nonroutine transactions because they are not part of the normal flow of transactions and specialized skills may be needed to perform the activity.

Generally, the transactions with the highest level of inherent risk are **estimation transactions**, which are transactions that are valued by developing accounting estimates. The activities used to develop the estimates have high inherent risk because they involve management judgments or assumptions and may be susceptible to management bias. Examples of estimation activities include estimating the allowance for uncollectible accounts, establishing warranty reserves, and evaluating assets for impairment.

The preceding types of transactions are ordinarily recorded through journal entries to the accounting records. Company accountants also often use “**top-side entries**” when preparing financial statements. Top-side entries generally are not posted within

³ The *assertion level* is also referred to as the *relevant assertion level* in various AICPA professional standards and other materials, generally when the risk assessment has identified various relevant assertions. We will use both terms interchangeably.

the client's journals and general ledger but are ordinarily made directly to a spreadsheet or similar schedule being used in the financial statement preparation process. These entries may relate to routine, nonroutine, or estimation transactions. Examples include consolidation entries, aggregation or disaggregation of certain accounts (e.g., combining the cash accounts), and currency translations. While the above types of entries may be appropriate, other top-side entries may not be appropriate. For example, a fraudulent top-side entry might increase earnings by recording a fictitious sale with a debit to accounts receivable and a credit to sales. Auditors need to be aware of and understand top-side entries because such entries may present a high risk of misstatement.

Control risk is the risk that a material misstatement could occur in a financial statement assertion and not be prevented, or detected and corrected, on a timely basis by internal control. It is a function of the effectiveness of both the design and operation of internal control in achieving the client's objectives relevant to the preparation of its financial statements.

Both inherent risk and control risk exist at the financial statement assertion level independently of the audit of financial statements. That is, the risk of material misstatement (composed of inherent risk and control risk) exists regardless of whether an audit is performed.

The AICPA requires auditors to make separate assessments (AU-C 315) of inherent risk and controls risk in assessing the risk of material misstatement. The PCAOB (AS 2110) allows auditors to either assess the risks separately or make a direct overall assessment (combining inherent and controls risk components for relevant assertions) of the risk of material misstatement.

Detection risk is the risk that the auditors' procedures will lead them to conclude that a financial statement assertion is not materially misstated when in fact such misstatement does exist. Detection risk is a function of the effectiveness of the audit procedures and their application by the auditors. Accordingly, unlike inherent risk and control risk, it does not exist when no audit is performed. Rather than "assessing" detection risk, auditors seek to restrict it through performance of substantive procedures.

Detection risk exists because the auditors' substantive procedures are not 100 percent effective at detecting all misstatements, due to both use of sampling and other factors. As discussed later in this chapter, substantive procedures of two general types are performed: (1) tests of details of balances, transactions, and disclosures and (2) substantive analytical procedures. For a given level of audit risk, detection risk varies inversely with the risk of material misstatement; for example, the greater the risk of material misstatement, the less the detection risk that can be accepted by the auditors.

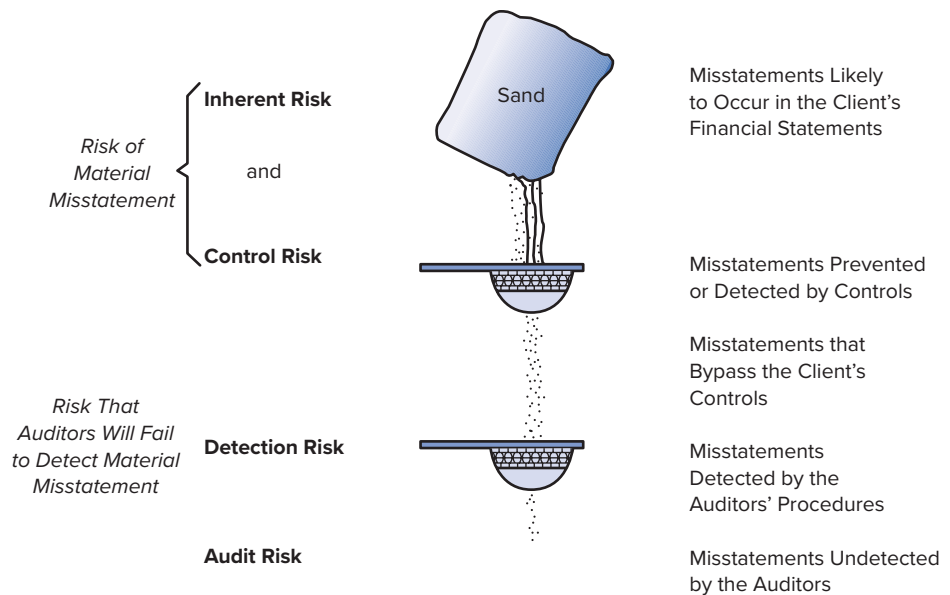
Audit Risk Illustrated

Figure 5.2 describes the interrelationships among the three components of audit risk. The bag of sand in the figure represents *inherent risk*, the susceptibility of an account balance to material misstatements. The sieves represent the ways by which the client and the auditors attempt to remove the risk of misstatements from the financial statements. The first sieve represents the client's internal control, and the risk that it will fail to detect or prevent a misstatement is *control risk*. The auditors' audit procedures are represented by the second sieve, and the risk that the auditor will fail to detect a misstatement is *detection risk*. The risk that the misstatements will get through both sieves is *audit risk*.

Measuring Audit Risk

Recall that at the assertion level, the risk of material misstatement is composed of inherent risk and control risk. For purposes of considering the relationships, we consider the two risks separately. The assessment of the risks of material misstatement (as well as detection risk) may be expressed in quantitative terms (e.g., percentages) or in nonquantitative terms (e.g., low, medium, high); in the following illustration, we use

FIGURE 5.2
An Illustration of
Audit Risk



the quantitative form. The auditing standards include the following formula to illustrate the relationships among audit risk, inherent risk, control risk, and detection risk.

$$AR = \underbrace{IR \times CR}_{RMM} \times DR$$

where

AR = Audit risk

IR = Inherent risk

CR = Control risk

DR = Detection risk

RMM = Risk of material misstatement

To illustrate how audit risk may be quantified, assume that the auditors have assessed inherent risk for a particular assertion at 50 percent and control risk at 40 percent. In addition, they have performed audit procedures that they believe have a 20 percent risk of failing to detect a material misstatement in the assertion. The audit risk for the assertion may be computed as follows:

$$\begin{aligned} AR &= IR \times CR \times DR \\ &= .50 \times .40 \times .20 = .04 \end{aligned}$$

Thus, the auditors face a 4 percent audit risk that a material misstatement has occurred and evaded both the client's controls and the auditors' procedures. Realize, however, that the model expresses general relationships and is not necessarily intended to be a mathematical model to precisely consider the factors that influence audit risk in actual audit situations.

As indicated previously, it is important to realize that while auditors gather evidence to *assess* inherent risk and control risk, they gather evidence to *restrict* detection risk to the appropriate level. Inherent risk and control risk are a function of the client and its operating environment. Regardless of how much evidence the auditors gather, they cannot change these risks. Therefore, evidence gathered by the auditors is used to assess the levels of inherent and control risk. Chapters 6, 7, and 10 through 16 discuss this important topic of assessing risks of material misstatement in greater detail.

Detection risk,⁴ on the other hand, is a function of the effectiveness of the audit procedures performed. If the auditors wish to reduce the level of detection risk, they simply obtain additional appropriate evidence. As a result, detection risk is the only risk that is completely a function of the sufficiency and appropriateness of the audit evidence obtained by the auditors.

Audit Evidence

Audit evidence includes all the information used by auditors in arriving at the conclusions on which the audit opinion is based. It includes the information contained in the accounting records underlying the financial statements, other internal information, and evidence obtained and developed from sources external to the entity to which audit procedures have been applied.

When auditors evaluate information used as audit evidence, they consider whether such information corroborates (supports) or contradicts the assertions in the financial statements. Certain information may confirm fairness of an assertion, while other information may be disconfirming. For example, the aging of accounts receivable may provide evidence about the allowance for doubtful accounts that corroborates the amount recorded in the financial statements. However, an analysis of several large year-end accounts receivable for which collection seems particularly questionable may provide contradictory evidence and suggest the need for a larger allowance. Such a situation may suggest the need to obtain additional evidence.

As discussed earlier in this section, auditors must *obtain* sufficient appropriate audit evidence to reduce audit risk to an appropriately low level. What constitutes sufficient appropriate audit evidence? Appropriateness relates to the quality of the audit evidence: its relevance and reliability. Sufficiency relates to the quantity of appropriate audit evidence required to sufficiently restrict audit risk. The mix of types and amounts of audit evidence needed is affected by the risk of material misstatement (the higher the risk, the stronger the audit evidence needed to persuade the auditors) and the quality of the total evidence. Often, the auditors find it necessary to rely on evidence that is persuasive rather than conclusive. Auditors are seldom convinced beyond *all* doubt that all aspects of the statements are properly stated.

In evaluating the appropriateness of audit evidence, auditors consider both its relevance and its reliability in providing support for, or detecting misstatements in, financial statement assertions. *Relevance* relates to the assertion being addressed. For example, confirming a client's accounts receivable with customers may provide relevant evidence on the existence of the receivables, but it provides very limited information relating to whether the client has completely recorded all receivable accounts.

The *reliability* of evidence is affected by factors such as its accuracy, completeness, authenticity, and susceptibility to management bias. While making generalizations is difficult and subject to exceptions, audit evidence may be more reliable when it is

1. Obtained from **external information sources** because it is considered less susceptible to management bias, though auditors must consider the reliability of the source.
2. Generated internally through a system of *effective controls* rather than ineffective controls.
3. Obtained *directly* by the auditors rather than indirectly or by inference (e.g., observation of application of a control is more reliable than the client's response to an inquiry concerning the application of the control).
4. *Documentary* in form (paper or electronic) rather than in the form of an oral representation.
5. Provided by *original documents* rather than documents that have been digitized or otherwise converted into electronic form, photocopies, or facsimiles, the reliability of which depends on the effectiveness of the controls over conversion and maintenance of those documents.

LO 5-3

Distinguish between the concepts of *sufficient* and *appropriate* as they apply to audit evidence.

⁴ The Appendix to Chapter 9 disaggregates detection risk into (1) tests of details (TD) and (2) risks related to substantive analytical procedures (AP).

As indicated, the preceding generalizations are subject to exceptions. As an example, independent sources outside the client may provide incorrect information. Such incorrect information may simply be due to an error made by the source, although there are other possibilities. An external source may be unduly influenced by management of the client—for example, a supplier that relies heavily on sales to the client may be persuaded by client management to provide inaccurate information to the auditors.

Audit evidence obtained from two or more sources that is consistent among the sources provides the auditors with more aggregate assurance than the items would provide if considered individually. Evidence that can be corroborated among sources provides greater assurance about the true state of the assertion being tested. For example, the auditors may inquire about the management review control designed to identify exceptions in the processing of cash disbursements, and they might also review reports that document exceptions and their disposition. The combined evidence may provide more assurance than either individually would provide. Conversely, if inconsistencies or contradictions arise between the sources of audit evidence, the auditors may derive little assurance with respect to the effective operation of the control.

Auditors perform audit procedures to obtain audit evidence that will allow them to draw reasonable conclusions as to whether the client's financial statements follow generally accepted accounting principles. When auditors evaluate whether they have sufficient appropriate audit evidence to draw reasonable conclusions throughout the audit, they must (1) apply professional skepticism; (2) assess (and reassess) the risks of material misstatement at the relevant assertion level; and (3) evaluate the nature, timing, and extent of the audit procedures performed.

Applying Professional Skepticism

In our Chapter 2 discussion of **professional skepticism**, we indicated that it includes maintaining a questioning mind, being alert to conditions that may indicate possible misstatements due to fraud or error, and critically assessing audit evidence. As a part of this process, auditors must constantly be aware of the possibility that they have received biased, or outright incorrect, information. Certainly, management is an involved party in the process, and information it provides may be less than entirely accurate for reasons such as (1) having significant investments in the company's stock, (2) receiving compensation tied to reported net income, or (3) concerns about showing poor company performance. Also, as we have indicated earlier, auditors need to be aware that management may have an effect on the reliability of information obtained from external sources. Auditors must consider the possibility of bias in external information when management:

- Has the ability to influence the source, or
- Selects sources it knows are favorably biased toward corroborating management's information.

Auditors must consider the susceptibility of information to management bias and also the unconscious or conscious bias in evaluating the audit evidence they exhibit. Also, auditors should be aware that a long history of psychological research⁵ has shown that human judgments (including those of auditors) are vulnerable to limitations that may result in insufficient skepticism and biased decisions. Examples of these **cognitive biases** include:

- *Anchoring bias*: Making judgments by starting from an initial belief and then making insufficient adjustments to the belief when contrary information is encountered. For example, the auditors may anchor on the recorded amount of a company's warranty liability and not sufficiently adjust their belief based on evidence that it is misstated.

⁵ Academic and professional research is available on cognitive biases through an Internet search of the topic. Work by Daniel Kahneman and Amos Tversky is highly regarded (e.g., the book *Thinking Fast and Slow* by Tversky). A brief, very readable, article, *How Cognitive Biases Influence How You Think and Act* (Kendra Cherry, 2019); updated November 7, 2022 is available at <https://www.verywellmind.com/what-is-a-cognitive-bias-2794963>. Verywell Mind, the publisher, is a partner with the highly regarded Cleveland Clinic medical facility.

- *Confirmation bias*: Seeking and treating as more persuasive information that is consistent with one's initial beliefs. For example, the auditors inadequately consider contradictory evidence that casts doubts on a change in operating results after other potential explanations for a change in operating results after management proposes an explanation that is consistent with the auditor's belief.
- *Availability bias*: Overvaluing information that comes to one's mind quickly or is easily obtained. For example, the auditors may assume that the cause of an unusual relationship is the same as they have experienced several times in prior audits.
- *Overconfidence bias*: Overestimating one's own abilities to make estimates or assessments. For example, the auditors may be overconfident in their ability to evaluate the accuracy of an accounting estimate and, as a result, not collect sufficient evidence.
- *Automation bias*: A tendency to favor output generated from automated systems, even when human reasoning or contradictory information raises questions as to whether such output is reliable or appropriate. For example, an estimate may be made electronically that is based on prior conditions that have now changed.

You should realize that these biases are not independent of one another. The auditors may make an error in judgment because of one or more of the biases. Also, while not a complete solution, being aware of such biases may improve the auditors' application of professional skepticism. This is particularly important since the PCAOB's inspections have revealed a recurring pattern of deficiencies in the application of professional skepticism, particularly in judgmental areas (e.g., evaluating accounting estimates) and in considering the possibility of management bias.

Assessing and Reassessing the Risks of Material Misstatement

The need for careful assessments of the risk of material misstatement is emphasized in the following chapter, and throughout the procedural chapters (Chapters 10 through 16) of the text. In sum, a risk-based approach is used in which "risky areas" are given more consideration than those areas in which it seems a material misstatement is unlikely.

The Nature, Timing, and Extent of the Audit Procedures Performed

Auditors address obtaining sufficient and appropriate audit evidence using the following overall types of procedures.

1. **Risk assessment procedures** are designed to obtain an understanding of the client and its environment, including its internal control, to assess the risks of material misstatement.
2. **Tests of controls** are designed to test the operating effectiveness of controls in preventing or detecting and correcting material misstatements.
3. **Substantive procedures** are designed to detect material misstatements of relevant assertions. Substantive procedures include (a) analytical procedures and (b) tests of details of account balances, classes of transactions, and disclosures.

Auditors attempt to use a cost-effective combination of the above procedures to draw reasonable conclusions. They can no more disregard the cost of alternative audit procedures than a store manager can disregard a difference in the cost of competing brands of merchandise. While cost is not the primary factor influencing auditors in deciding what evidence should be obtained, it is always an important consideration. Also, the greater the risk of material misstatement of the item to be audited, the stronger the evidence required by the auditors, and the greater the cost they are willing to incur in obtaining it. As we have indicated, sufficient appropriate audit evidence is obtained when audit risk is reduced to an acceptable level. Subject to a requirement that some substantive procedures should be performed relating to all relevant assertions, the auditors seek the most efficient (lowest cost) set of audit procedures that achieves the required low level of audit risk. Chapters 6 and 7 provide basic guidance on risk assessment procedures and on tests of controls. Later in this chapter we will provide an overview of substantive procedures.

Types of Audit Procedures

LO 5-4

List and describe types of audit procedures.

The auditors perform a variety of audit procedures to obtain audit evidence, including

1. Inspection of records and documents.
2. Inquiry of knowledgeable persons within and outside the entity.
3. External confirmation.
4. Inspection of tangible assets.
5. Observation of processes or procedures being performed by others.
6. Recalculation of mathematical accuracy.
7. Repperformance of procedures.
8. Analytical procedures.

1. Inspection of Records and Documents

Audit evidence in paper or electronic form that is obtained through inspection of records and documents is referred to as documentary evidence. It includes examination of a variety of records supporting the company's business and accounting information system such as checks, invoices, minutes of meetings, and contracts. For example, the auditors may read contracts manually or use automated techniques such as text-recognition programs to identify items for further audit consideration.

Many documents provide direct support for certain assertions about the numbers and disclosures included in the financial statements. Examples include:

- Sales invoices provide direct evidence of the *occurrence* and *accuracy* of sales, but less evidence on the completeness of the recording of sales.
- A purchase invoice may provide direct audit evidence of the original valuation (cost) of a plant asset used for depreciation purposes, while providing less audit evidence as to *rights* (current ownership) or current *valuation* of the asset.

The reliability of documentary evidence depends in part on whether it was created within the company (e.g., a sales invoice) or outside the company (e.g., a vendor's invoice). Some documents created within the company (e.g., checks) are sent outside the organization for endorsement and processing; because of this critical review by outsiders, these documents are regarded as more reliable than other documents created by client personnel.

In appraising the reliability of documentary evidence, the auditors should be aware that documents may be forged or created in their entirety by a dishonest employee. For example, a creative individual may be able to easily create invoices and other business documents using document editors or a digital copier.

Documentary Evidence Created Outside the Client Organization and Transmitted Directly to the Auditors A few documents are prepared outside the client organization and transmitted directly to the auditors. An example is a *cutoff bank statement*, which is a bank statement covering a specified number of business days (usually 7–10) after the client's balance sheet date. Auditors use this statement to determine that reconciling items shown on the year-end bank statement are complete and have cleared the bank within a reasonable time. Cutoff bank statements are discussed in more detail in Chapter 10.

The auditors will often be provided with access to electronic client records maintained by a third party (e.g., electronic bank statements and processed electronic copies of checks that have been paid that are maintained by the client's bank). In these circumstances, the auditors should assess the security of the records and consider whether they have been given access to all relevant records.

Other information created outside the client organization used as evidence may be published by an external individual or organization. Examples of such information are real estate prices, actuarial mortality tables, industry ratios and risk measures, economic data, and market trends. Increasingly, these data are used by auditors to perform **audit data analytics**, which, as discussed later in this chapter, involves the analysis of patterns, identification of anomalies, or extraction of other useful information. The reliability of

the data provided by such external information sources depends upon the individual or organization involved. In evaluating the reliability of the source, auditors may be able to compare previous information provided with subsequent actual results.

Documentary Evidence Created Outside the Client Organization and Held by the Client

Many externally created documents examined by the auditors will be in the client's possession. Examples include bank statements, vendors' invoices and statements, property tax bills, notes payable, contracts, customers' purchase orders, and bond certificates. In deciding how much reliance to place upon this type of evidence, the auditors should consider whether the document is of a type that could be easily created or altered by client personnel. The auditors should be particularly cautious in accepting as audit evidence photo or other copies of documents, or documents that appear to have been altered in any way. Copies of documents generally may be easily altered in a manner that makes detection difficult. Alterations to a document may have been made deliberately to misstate the facts and to mislead auditors or others who rely upon the document. Yet, externally created documents in the possession of the client are used extensively by auditors and are ordinarily considered as relatively reliable evidence.

Documentary Evidence Created within the Client Organization

When available, the most reliable single piece of *documentary evidence* created within the client's organization ordinarily is a paid check. The check (or its electronically processed copy) bears the endorsement of the payee and a perforation or stamp indicating payment by the bank. Because of this review and processing of a check by outsiders, the auditors will usually look upon a paid check as a strong type of evidence. The paid check (or its electronically processed copy) may be viewed as evidence that an asset was acquired at a given cost, or as proof that a liability was paid or an expense incurred.

Most documents created within the client organization represent a lower quality of evidence than a processed check because they circulate only within the company and do not receive the critical review of an outsider. Examples of internally created documents that do not leave the client's possession are client copies of sales invoices, shipping notices, purchase orders, receiving reports, and credit memoranda. Of course, the original copy of a sales invoice or purchase order is sent to the customer or supplier, but the copy available for the auditors' inspection has not left the client's possession.

The degree of reliance to be placed on documents created and used only within the organization depends on the effectiveness of the system of internal control. If the controls are so designed that a document prepared by one person must be critically reviewed by another, and if all documents are controlled by the computer system or are serially numbered with all numbers in the series accounted for, these documents may represent reasonably reliable evidence. Adequate internal control also will provide for extensive segregation of duties so that no one employee handles a transaction from beginning to end. An employee who maintains records (recordkeeping) or creates documents, such as credit memoranda (authorization), should not have access to cash (custody). Under these conditions, there is no opportunity for an employee to falsify a document because the employee creating documents does not have custody of assets.

On the other hand, if internal control is weak, the auditors cannot place as much reliance on documentary evidence created within the organization and not reviewed by outsiders. If an employee is authorized to create documents such as sales invoices and credit memoranda and also has access to cash, an opportunity exists to falsify documents to conceal an error or a theft. If documents are not controlled by serial numbers, the possibility arises that the auditors do not have access to all documents or that duplicates are being used to support fictitious transactions. Not only is there the danger of fictitious documents being created to cover theft by an employee, but also there is the possibility that management is purposely presenting misleading financial statements and has prepared false supporting documents for the purpose of deceiving the auditors.

When information, whether originally created within or outside the organization, has been transformed from its original medium (for example, physical documents have been

filmed, digitized, or otherwise transformed to electronic form), the reliability of that information may depend on the controls over the information's transformation and maintenance. In some situations, the auditor may determine that additional audit procedures are necessary to address reliability (for example, inspecting underlying original documents to validate the authenticity of information in electronic form). In other situations, the auditor may determine that it is necessary to test controls over the transformation and maintenance of the information.

Electronic Data Interchange **Electronic data interchange (EDI)** involves the transmission of data between organizations by electronic means. It is more than "e-mail ordering" in that electronic documents or business data flow from one company to another, often without human intervention. Human intervention in the processing often only occurs for errors, review, and special circumstances. As an illustration, when an inventory system registers a low level of inventory, a purchase transaction may be automatically initiated by a client's computer by sending an electronic message directly to a supplier's computer system. This electronic message replaces the traditional purchase order. The other documentation of the purchase transaction may consist of an invoice and a bill of lading generated in electronic form by the supplier's computer system. To determine the degree of reliance that may be placed upon such electronic documents, the auditors will test the controls over the computer system. Chapter 8 describes the controls that are used in computerized information systems in detail, and Chapters 10 through 16 include illustrations of such systems.

2. Inquiry of Knowledgeable Persons within and outside the Entity

Auditors obtain a variety of representations from a number of company personnel and outside parties (e.g., the client's customers, vendors, financial institutions, and attorneys). In addition, evidence is obtained from specialists in many audits. Inquiries, which may be oral or written, may result in either oral or written replies.

Throughout an audit, the auditors ask a great many questions of the officers and employees of the client's organization. Oral inquiries are made on an endless range of topics: the location of records and documents, the reasons underlying an unusual accounting procedure, the probabilities of collecting a long-past-due account receivable. In making inquiries, auditors should consider the knowledge, objectivity, experience, responsibility, and qualifications of the individual being questioned and should use carefully structured questions to address relevant issues. Client replies should be carefully evaluated for possible bias and inaccuracy (intentional or unintentional). In addition, the auditors should follow up with additional questions as considered appropriate.

Generally, oral client representations are not sufficient in themselves, but they may be useful in disclosing situations that require investigation or corroboration with other



Illustrative Case

Reliance on Management Representations

The income statement of the National Student Marketing Corporation (NSMC) included total gains of \$370,000 from the sale of two subsidiary companies to employees of the subsidiaries. Consideration for the sale was notes receivable collateralized by 7,700 shares of NSMC stock. Because both subsidiaries had been operating at substantial losses, NSMC's independent auditors obtained written representations from three officers of NSMC that there were no indemnification or repurchase commitments given to the purchasers.

The SEC criticized the auditors for relying too heavily on management representations regarding the sales. The SEC considered the sales to be sham transactions that would have been brought to light had the auditors sufficiently extended their audit procedures. NSMC had executed various side agreements to assume all risks of ownership after the "sale" of one subsidiary and had agreed to make cash contributions and guarantee a bank line of credit for the other subsidiary after the "sale." Further, the NSMC stock collateralizing the notes receivable had been given to the subsidiaries' "purchasers" by officers of NSMC.

forms of evidence. For example, after making a detailed analysis of all past-due accounts receivable, an auditor will normally discuss with the credit manager the prospects of collecting specific accounts. If the opinions of the credit manager are in accordance with the independent expectations developed by the auditor, this oral evidence will constitute support for the conclusions reached and provide evidence for the evaluation of the valuation assertion. In repeat audits of a business, the auditors will be in a better position to evaluate the opinions of the credit manager based on the quality of the manager's estimates in prior years.

Representation Letters Auditors also obtain written representations from clients. At the conclusion of the audit, the CPAs obtain from client officers a written **representation letter** summarizing the most important oral representations made by management during the engagement. Many specific items are included in this representation letter. For example, management usually represents that all liabilities known to exist are reflected in the financial statements. The representations generally fall into the following broad categories:

1. All accounting records, financial data, and minutes of directors' meetings have been made available to the auditors.
2. The financial statements are complete and were prepared in conformity with generally accepted accounting principles.
3. Management believes that the adjusting entries brought to its attention by the auditors and not recorded are not material, individually or in the aggregate.
4. Management acknowledges its responsibility to design and implement programs and controls to prevent and detect fraud and to disclose information to the auditors on alleged or suspected fraud.
5. All items requiring disclosure (such as loss contingencies, noncompliance with laws and regulations, and related party transactions) have been properly disclosed.

Both the AICPA (AU-C 580) and the PCAOB (AS 2805) require auditors to obtain a representation letter on every engagement and provide suggestions as to its form and content. These letters are dated as of the **date of the auditors' report** and usually are signed by both the client's chief executive officer and chief financial officer.

A client representation letter *should never be used as a substitute for performing other audit procedures*. The financial statements already constitute written representation by the client; hence, a representation letter does little more than assert that the original representations were correct.

Although representation letters are not a substitute for other necessary audit procedures, they do serve several important audit purposes. One purpose is to remind the client officers of their primary and personal responsibility for the financial statements. Another purpose is to document in the audit working papers the client's responses to the significant questions asked by the auditors during the engagement. Also, a representation by management may be the only evidence available with respect to management's *future intentions*. For example, whether maturing debt is classified as a current or a long-term liability may depend upon whether management has both the ability and the *intent* to refinance the debt.

Inquiries Resulting in Lawyers' Letters The primary source of information about litigation that is pending against the client is obtained from *lawyers' letters*. To obtain these letters, the auditors ask the client to request their attorneys to furnish directly to the auditors their assessment or concurrence with management's assessment of any litigation being handled for the client. Lawyers' letters are discussed in Chapter 16.

Inquiries of Specialists Auditors may not be experts in performing such technical tasks as judging the value of highly specialized inventory or making actuarial computations to verify liabilities for postretirement benefits. Audit evidence about such matters is best obtained from a qualified **specialist**. Other examples of audit tasks that may require the use of a specialist include valuation of works of art, valuation of restricted securities, and legal interpretation of regulations or contracts.



Illustrative Case

Need for a Specialist

During the observation of the physical inventory of a company manufacturing semiconductors, one of the auditors counted semiconductors purportedly worth several hundred thousand dollars. He then asked why apparently identical-appearing semiconductors on another wall were not being counted. The client informed him that those semiconductors were defective and could not be sold. To the auditor,

the defective semiconductors were identical in appearance with those included in the count. In a situation such as this, to the extent that effects on the financial statements are potentially material, the auditors may need to obtain additional evidence about the valuation of the inventory. This might involve obtaining evidence about controls over identification of defective inventory, or engaging a specialist to evaluate the valuation of the semiconductors.

Both AICPA (AU-C 620) and PCAOB (AS 1105, 1201, 1210) recognize the necessity for auditors to consult with experts, when appropriate, as a means of gathering sufficient appropriate audit evidence. A **specialist** is an individual or organization possessing expertise in a field other than accounting and auditing, such as expertise in valuation of complex financial instruments and other assets, actuarial calculations, estimation of oil and gas reserves, and valuation of environmental liabilities. The specialist may be hired by the client (the “management’s specialist”) or by the auditors (the “auditors’ specialist”). Also, a specialist may be either an employee of the auditing firm or client or a nonemployee engaged to perform one or more services. A specialist that is an auditing firm employee is considered an engagement team member.

When a client’s specialist is involved (either employed or engaged), the audit emphasis is on

- Assessing the knowledge, skill, and ability of the company’s specialist and the specialist’s relationship to the company.
- Testing the accuracy and completeness of company-produced data used by the specialist and evaluating the relevance and reliability of outside data used.
- Evaluating whether the specialist’s methods seem appropriate and the significant assumptions reasonable.
- Evaluating whether the specialist’s work is relevant and reliable and whether the findings support or contradict relevant financial statement assertions. Related, if the auditors believe that the specialist’s objectivity might be impaired (e.g., due to the ability of management to influence the specialist), they should perform additional procedures or hire another specialist.

When an auditor-employed or auditor-engaged specialist is involved, a major issue for the audit team is one of proper audit team coordination with the specialist. While the above requirements for a client specialist remain relevant, the emphasis will include an evaluation of whether the specialist’s work is in accordance with the auditors’ requirements and whether the specialist’s findings and conclusions are consistent with the results of the overall work performed.

As implied, it is important that auditors do not accept a specialist’s findings blindly. They should obtain an adequate understanding of the methods or assumptions used by the specialist and evaluate their relevance and reasonableness in relation to the auditors’ other findings and conclusions.

The auditors should not refer to the specialist in their audit report unless (1) such reference will facilitate reader understanding of a **key** or **critical audit matter**⁶ or

⁶ Chapter 17 discusses the nature and reporting of key audit matters (in nonpublic company audit reports) and critical audit matters (in public company audit reports) in detail.

(2) the specialist's findings do not support the representations in the financial statements, thus causing the auditors to modify their opinion. Thus, when an unmodified opinion is issued, a specialist is not referred to in the audit report unless that specialist's work is referenced in a discussion of a critical audit matter.

3. External Confirmation

Confirmation requests are used in the audit of a number of accounts, including cash, accounts and notes receivable, debt accounts, and capital stock accounts. As an example, in the audit of accounts receivable, customers are requested by the client to send a reply (through the mail or electronically) directly to the auditors that confirms the amount owed to the client.

As indicated in AICPA AU-C 505 (PCAOB AS 2310), confirmation requests to third parties (e.g., customers, vendors, financial institutions) can be used to address any of the assertions about a particular financial statement amount. However, they do not address all assertions equally well. Confirmations generally are effective at providing evidence about the assertion of *existence* of accounts, but they are less effective at addressing *completeness* and the appropriate *valuation*. For example, while a returned account receivable confirmation may provide reliable evidence about the existence of a client asset (an obligation to the debtor), it does not address whether the debtor can actually pay the obligation. The account actually may be worthless.

To ensure the reliability of the confirmation process, the auditors should carefully design the confirmation requests to seek the appropriate information and make it easy for the recipient to respond. The auditors also should consider whether it is necessary to specifically address the confirmation request to an individual in the outside organization who is authorized to confirm the information. As an example, information about the terms of a debt agreement at a financial institution might best be sent to the appropriate financial institution loan officer.

While the confirmation process is often performed electronically, when auditors mail confirmations they ordinarily do it from their office, or directly from a post office branch, not from the client's premises. Also, to obtain assurance that the confirmation reply comes directly to the auditors and not to the client, the auditors will enclose with the confirmation request a return envelope addressed to the auditors' office. If the replies were addressed to the auditors at the client's place of business, an opportunity would exist for someone in the client's organization to intercept a returned confirmation and alter the information reported, or even destroy the document. The envelope containing the confirmation should bear the auditors' return address. In that way, if the address is fictitious, the confirmation may be returned by the post office directly to the auditors. As discussed in more detail in Chapter 11, when information is confirmed electronically, procedures should be followed to ensure that the process is secure.

4. Inspection of Tangible Assets

Inspection of tangible assets by the auditors ordinarily provides direct evidence of the existence of the assets. Evidence about the existence of cash on hand may be obtained by inspection. Similarly, the existence of property, plant, and equipment, such as automobiles, buildings, office equipment, and factory machinery, may be conclusively established by inspecting those assets. While this is often performed manually by the auditors, in certain circumstances, automated techniques (e.g., the use of drones) are often possible and cost justified, particularly when such assets are in differing locations.

At first thought, it might seem that inspection of an asset would conclusively verify all assertions relating to the account, but this is often not true. For example, inspecting factory machinery may not address whether it is properly valued (e.g., whether the allowance for accumulated depreciation is proper or whether a particular machine is obsolete). Similarly, the auditors' inspection of tangible assets also does not provide proof of ownership of assets. A fleet of automobiles used by salespeople and company executives, for example, might be leased rather than owned. In addition, physical examination does not substantiate the cost of the assets.

In summary, inspection provides high-quality evidence as to the *existence* of certain assets, but generally it needs to be supplemented by other types of evidence to determine the ownership rights, proper valuation, and condition of those assets. For some types of assets, such as accounts receivable or intangible assets, the existence of the assets cannot be verified through physical inspection.

5. Observation of Processes or Procedures Being Performed by Others

Observation involves watching a process or procedure being performed by others. Examples include observing custodial controls or observing performance of a control activity, such as the auditors' observation of a clerk performing a reconciliation or of the inventory counting by the client's personnel. Remote observation tools (for example, a camera mounted to a drone or other video transmission) may aid the auditor in performing an observation procedure, such as management's physical inventory count.

6. Recalculation of Mathematical Accuracy

Another type of audit evidence consists of recalculations made independently by the auditors to prove the arithmetical accuracy of the client's analyses and records. At a high level, this should include making certain that accounting records (e.g., accounts in the general ledger) agree with or can be reconciled to the financial statements. At a more detailed level, the auditor's computations might consist of footing (i.e., totaling) a column of figures in a sales journal or in a ledger account to prove that column total. Independent computations may be used to prove the accuracy of such client calculations as earnings per share, depreciation expense, allowance for uncollectible accounts, revenue recognized on a percentage-of-completion basis, and provisions for federal and state income taxes. Also, by using automated tools and techniques, auditors may be able to perform recalculation procedures on 100 percent of a population such as recalculating the gross margin for each product sold.

Specialists may become involved in certain calculations. For example, because the computation of a client's liability for postretirement benefits involves actuarial assumptions and computations beyond the auditors' area of expertise, auditors usually rely on the services of an actuary to compute this liability.

7. Reperformance of Procedures

Reperformance involves the auditors independently performing procedures or activities that were originally performed by the client, ordinarily as a part of the company's system of internal control. For example, an auditor may manually or electronically compare the price on an invoice to that on an approved price list or reperform the computation of the aging of accounts receivable. An exception identified suggests ineffective operation of the control in that instance.

8. Analytical Procedures

Analytical procedures, discussed in detail later in this chapter, involve the comparison of relationships among financial and, sometimes, nonfinancial data. Data interrelationships rely upon plausible relationships among both financial and nonfinancial data. For example, a plausible relationship may exist in an industry between square footage of sales space and retail sales.

Scanning is a type of analytical procedure in which auditors use professional judgment to review accounting data to identify significant or unusual items and then select those items for testing. For example, an auditor may search for large or unusual items in the accounting records (e.g., nonstandard journal entries) for indication of misstatements. Audit data analytics may also be used to identify significant or unusual transactions that represent a risk of misstatement. For example, software is available that may be used to identify unusual journal entries using a combination of algorithms designed into the software or by the auditors; indeed, such tests may be run on the entire population of transactions.

Figure 5.3 summarizes the various types of audit procedures and provides examples.

FIGURE 5.3 Audit Procedures

Audit Procedure	Example
Inspection of records or documents —Examining a record or document	- Inspect certain records as evidence of ownership (e.g., deed on land) - A test of controls to inspect records for evidence of proper authorization
Inquiry —Seeking information of knowledgeable persons within or outside the organization; inquiry may be oral or written	- Inquiry of plant manager as to a sequence of operations - Inquiry of attorney relating to litigation
External confirmation —Obtaining a written response about a particular item from a third party (e.g., debtor, creditor)	Confirmation of accounts receivable
Inspection of tangible assets —Physically examining an asset	Inspect the condition of inventory items
Observation —Watching a process or procedure being performed by the entity's personnel or the performance of control activities	- Observe client personnel performing manufacturing functions - Observe the client counting its inventory
Recalculation —Testing the mathematical accuracy of documents or records	Using audit data analytics to determine whether data in a file has been summarized properly by the client
Reperformance —An independent execution of procedures or controls that were originally performed by the client (often as a part of the client's internal control)	Reperforming the aging of accounts receivable manually or by using audit data analytics
Analytical procedures —Evaluations of financial information through analysis of plausible relationships among financial and nonfinancial data	Calculating days' credit sales in ending accounts receivable and comparing to the prior year
Scanning —Use of professional judgment to review accounting data to identify significant unusual items that will be tested (often as a part of analytical procedures)	- Scanning the general journal for unusual entries - Applying audit data analytics to identify unusual payments in the payroll register

Substantive Procedures

In thinking about substantive procedures, it is helpful to consider their nature (type and form), timing (when performed), and extent (quantity of evidence obtained).

Types of Substantive Procedures

Substantive procedures include substantive analytical procedures and tests of details. These tests are part of the auditors' **further audit procedures**⁷ because their nature, timing, and extent are based on the results of the risk assessment procedures. Tests of details may be divided into three types: (1) tests of account balances, (2) tests of classes of transactions, and (3) tests of disclosures. Recall that this is the manner in which the assertions are presented in Figure 5.1. Tests of details of balances directly address whether there are misstatements in the ending balance of an account (e.g., confirmation of ending accounts receivable balances). Tests of details of transactions (also referred to as direct tests of transactions) address whether particular types of transactions (e.g., sales transactions) are valid and have been properly accounted for during the period. Tests of details of disclosures address whether financial statement disclosures are properly presented.

Nature of Substantive Procedures

The nature of the substantive procedures used on an audit will be responsive to the assessed risks of misstatement, with the objective of efficiently obtaining sufficient appropriate audit evidence to achieve the planned level of assurance for each audit area. One way for the auditors to address a high-risk area is to select a more effective audit procedure (i.e., an audit procedure that will produce more reliable audit evidence).

⁷ Further audit procedures include the tests of controls and substantive procedures that are performed based on the results of the auditors' risk assessments.

For example, if the auditors want to increase the assurance obtained relating to the existence of accounts receivable, they could decide to directly test the ending balance by confirming the accounts rather than relying upon the inspection of internal documents.

Timing of Substantive Procedures

Audit procedures may be performed before the client's year-end (i.e., at interim dates) or subsequent to year-end. The auditors may obtain more assurance by shifting audit procedures from an interim date to after year-end. Performing procedures at an interim date increases audit risk because material misstatements may arise in the remaining period between the date of the tests and year-end. This incremental audit risk should be controlled by performing additional audit procedures that cover the remaining period, or assurance by the auditors that the client's controls are operating effectively to prevent material misstatements. The timing of audit procedures is discussed in more detail in Chapter 6.

Extent of Substantive Procedures

Substantive procedures are required in response to the risks of misstatement of relevant assertions. Holding other factors such as the nature and timing of procedures constant, the greater the risk of material misstatement, the greater the needed extent of substantive procedures. The main way in which the auditors increase the extent of substantive tests of transactions and balances is to examine more items. Although later in the chapter we will discuss data analytics approaches that may allow the low-cost examination of entire populations in certain circumstances, in general, to be cost-effective, audits involve the use of samples. Audit sample sizes should be sufficient to restrict audit risk to a low level. The considerations used in determining appropriate sample sizes are described in Chapter 9.

Analytical Procedures

Analytical procedures involve evaluations of financial statement information by a study of relationships among financial and nonfinancial data. A basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary. Therefore, the auditors can use these relationships to obtain evidence about the reasonableness of financial statement amounts. AICPA AU-C 520 (PCAOB AS 2305) provides guidance on the nature of these procedures and examples of how they are applied.

Nature of Analytical Procedures

Techniques used in performing analytical procedures range in sophistication from straightforward analysis of trends and ratios to complex mathematical models involving many relationships and data from many previous years. A simple analytical procedure is to compare revenue and expense amounts for the current year to those of prior periods, noting significant differences. A more sophisticated analytical procedure might involve the development of a multiple regression model to estimate the amount of sales for the year using economic and industry data. Analytical procedures also may involve computations of percentage relationships of various items in the financial statements, such as gross profit percentages. Therefore, analytical procedures range from descriptive to predictive in nature. In all these approaches, the auditors attempt to identify unexpected differences or the absence of expected differences. Such differences may indicate misstatements in the financial statements that should be investigated fully by the auditors.

Essentially, the process of performing analytical procedures consists of four steps:

1. Develop an expectation of an account (or ratio) balance.
2. Determine the amount of difference from the expectation that can be accepted without investigation.
3. Compare the company's account (ratio) balance with the expectation, such as gross profit margin.
4. Investigate and evaluate significant differences from the expectation.

Develop an Expectation

A variety of types of information are available to the auditors to develop expectations for analytical procedures, including

1. Financial information for comparable prior periods.
2. Anticipated results, such as budgets and forecasts.
3. Relationships among elements of financial information within a period, such as gross profit margin.
4. Information derived from similar firms in the same industry, such as industry averages.
5. Relationships between financial information and relevant nonfinancial data.

Every audit client generates internal financial information that may be used in performing analytical procedures. Financial reports of prior years, forecasts, production reports, and monthly performance reports are but a few data sources that may be expected to bear predictable relationships to financial statement amounts. In establishing these relationships, auditors may use dollar amounts, physical quantities, ratios, or percentages. To increase the precision of the procedures, separate relationships may be computed for each division or product line. Also, developing expectations (e.g., sales) based on monthly measures often will provide a more precise expectation than will developing an expectation based on annual sales revenue. The level of data aggregation impacts the precision of the estimate: the more disaggregated the data, the more precise the estimate that may be developed.

Industry averages are available through such sources as Dun & Bradstreet's *Key Business Ratios* and Robert Morris Associates' *Annual Statement Studies*. These averages provide a potentially rich source of information for developing expectations for analytical procedures. Comparisons with industry statistics may alert auditors to classification errors, improper applications of accounting principles, or other misstatements in specific items in the client's financial statements. In addition, these comparisons may highlight the client's strengths and weaknesses relative to similar companies, and provide insight through key performance indicators, thus providing the auditors with a basis for making constructive recommendations to the client.

Certain problems may be encountered in using industry averages for analytical procedures because of a lack of comparability among companies and the inability to obtain current industry data. In comparison to the auditors' client, other companies in the same industry may be larger or smaller, engage in other lines of business that affect their ratios, or use different accounting methods. In addition, the time required to assemble industry averages creates a situation in which the most recent averages are always a year or so old. Thus, auditors should carefully consider the comparability and timeliness of the data before drawing conclusions based upon comparisons with industry averages.

Types of Expectations

Auditors develop expectations using a number of different techniques, including trend analysis, ratio analysis, regression analysis, and reasonableness tests. *Trend analysis* involves the review of changes in an account balance over time. For example, a review of the client's sales for the past three years might reveal a consistent growth rate of about 7 percent. This information would assist the auditors in developing an expectation about what sales should be for the current year.

Ratio analysis involves comparisons of relationships between two or more financial statement accounts, or comparisons of account balances to nonfinancial data (e.g., revenue per sales order). Traditional financial ratios typically are classified into four categories:

1. Liquidity ratios, such as the current ratio and the quick ratio.
2. Leverage ratios, such as the debt to equity ratio and the long-term debt to equity ratio.
3. Profitability ratios, such as gross profit percentage and return on total assets.
4. Activity ratios, such as inventory turnover and accounts receivable turnover.

Because ratio analysis involves examination of the relationships between two or more variables and may involve industry data, it is often a richer form of analysis than is trend analysis.

There are two basic approaches to ratio analysis: horizontal analysis and cross-sectional analysis. While **horizontal analysis** involves a review of client financial statement amounts and ratios over time, **cross-sectional analysis** involves comparisons with similar firms at a point in time, often comparing the client's ratios to industry averages.

Figure 5.4 provides an illustration of horizontal (trend) and cross-sectional analysis of a client's income statement. The figure also illustrates a *common-size* income statement, in which all revenues and expenses are presented as a percentage of net sales. A common-size income statement is particularly useful because many expenses, such as cost of goods sold, would be expected to bear a predictable relationship to net sales. A common-size balance sheet presents all assets, liabilities, and owners' equity amounts as a percentage of total assets. The development of **common-size financial statements** is also known as **vertical analysis**.

If the auditors decide to use a more sophisticated analysis, it will often take the form of regression analysis. *Regression analysis* involves the use of statistical models to quantify the auditors' expectation about a financial statement amount or ratio. As an example, the auditors could develop an expectation about the client's sales for this year with a model that uses the amount spent on advertising, the square footage of selling space, and consumer personal disposable income. Regression analysis has advantages over other forms of analysis in that more variables may be used to predict the financial statement balance, and the reliability and precision of the expectation may be precisely measured.

Another method that is used to develop a more precise expectation of a financial statement balance is a reasonableness test. A *reasonableness test* is similar to regression analysis in that an explicit expectation is computed for the financial statement amount using financial or nonfinancial data. As an example, the auditors might use the average occupancy rate and the average room rates of a hotel to develop an estimate of the hotel's revenues for the period.

A reasonableness test differs from regression analysis in that it is less formal and is not based on a statistical model.

Determine Amount of Difference That Can Be Accepted

The amount of difference between the expectation and the financial statement balance or ratio that can be accepted without investigation is determined primarily by the amount that is considered to be a material misstatement. However, this amount should be consistent with the degree of assurance desired from the procedure. If regression analysis is used, the items that should be investigated will be specifically identified by the statistical model based on the degree of precision and reliability specified by the auditors. When trend or ratio analysis is used, the auditors typically use professional judgment to specify an absolute amount of difference or a percentage difference that will result in investigation.

Compare the Account (Ratio) Balance with the Expected Balance

When the auditors have developed an independent expectation and the amount of difference that can be accepted, they can make comparisons between their independent expectation and the actual results to determine where significant differences lie.

Investigate and Evaluate Significant Differences

The auditors should investigate any significant differences between their expectations and the client's financial statement amounts or ratios to determine whether they represent misstatements. This may involve reconsidering the methods and factors used in developing the expectation. Inquiry of management may be of assistance in this regard. Management's explanations, however, should ordinarily be corroborated with other audit evidence. If the auditors are unable to corroborate management's explanation or management has no explanation, they will often be required to expand their tests of the related financial statement amounts to determine whether or not they are materially misstated.

FIGURE 5.4 Techniques for Analytical Procedures

Brody Corporation Income Statement						
	Dollars (000s Omitted)			Common-Size Statements		
	20X6 (Audited)	20X7 (Audited)	Percent Change	20X8 (Unaudited)	20X7 (Audited)	20X8 (Unaudited)
Gross sales	78,428	82,212	4.8	88,236	103%	103%
Less: Returns and allowances	2,284	4,235	85.4	2,644	3%	3%
Net sales	76,144	77,977	2.4	85,592	100%	100%
Cost of goods sold	46,213	46,478	0.6	51,234	60%	60%
Gross profit	29,931	31,499	5.2	34,358	40%	40%
Selling & administrative expenses	20,105	22,487	11.8	21,834	26%	26%
Income from operations	9,826	9,012	-8.3	12,524	12%	15%
Interest expense	1,930	1,584	-17.9	3,189	2%	4%
Net income before taxes	7,896	7,428	-5.9	9,335	10%	11%
Income taxes	3,807	6,189	62.6	7,761	8%	9%
Net income	4,089	1,239	-69.7	1,574	2%	2%
EPS	0.78	0.24	-69.2	0.30		
Ratios						
Current	1.7	1.9		1.9		2.1
Quick	1.0	1.1		1.1		1.3
Receivables turnover	5.3	5.6		4.7		5.1
Days' sales in ending receivables	68.1	64.3		76.6		65.6
Inventory turnover	4.7	3.2		1.7		3.5
Days' sales in ending inventory	76.0	75.0		112.5		74.4
Interest expense/outstanding debt	0.11	0.08		0.08		0.09
	Horizontal (Trend) Analysis			Vertical Analysis		Cross-Sectional Analysis

FIGURE 5.5 Potential Misstatements Disclosed by Analytical Procedures

Analytical Procedure	Potential Misstatements
1. Comparison of inventory levels for the current year to those of prior years	Misstatement of inventory; inventory obsolescence problem; misappropriation of inventory
2. Comparison of research and development expense to the budgeted amount	Misclassification of research and development expenses
3. Comparison of accounts receivable turnover for the current year to that of prior years	Misstatement of sales or accounts receivable; misstatement of the allowance for uncollectible accounts
4. Comparison of the client's gross profit percentage to published industry averages	Misstatement of sales and accounts receivable; misstatement of cost of goods sold and inventory
5. Comparison of production records in units to sales	Misstatement of sales; misstatement of inventory
6. Comparison of interest expense to the average outstanding balance of interest-bearing debt	Understatement of liabilities; misstatement of interest expense

Figure 5.5 provides some of the misstatements or problems that may be discovered when the auditors investigate significant differences uncovered by various analytical procedures.

Effects of Journal Entries on Ratios

Journal entries sometimes have a less-than-obvious effect on ratios. For example, consider the third item in Figure 5.5—comparison of the accounts receivable turnover (credit sales/accounts receivable) for the current year to that of prior years. A change in the accounts receivable turnover may be due to a change in credit sales, accounts receivable, or both. Given that credit sales are recorded with a debit to accounts receivable and a credit to sales, a credit sale recorded near year-end will affect both the numerator and the denominator when that receivable remains unpaid as of year-end. For simplicity sake, assume the accounts receivable turnover ratio at the close of year 1 is 7, with sales of \$700,000 and accounts receivable of \$100,000.

Now assume that a \$50,000 credit sale is recorded on December 31—the sale may be entirely appropriate, or inappropriate depending upon its circumstances (satisfaction of performance obligation). Recording the sale will result in year-end totals of \$750,000 in sales and \$150,000 of accounts receivable—decreasing the turnover to 5. Therefore, a recorded credit sale at year-end is a possible explanation for a decrease in the accounts receivable turnover. However, a variety of other circumstances also could cause a decrease in the accounts receivable turnover, including

- Decreased sales to \$500,000 with no change in accounts receivable, both due to a recessionary economy.
- Unchanged sales with an increase in accounts receivable to \$140,000 due to difficulties encountered in collecting receivables, thus requiring consideration of the adequacy of the allowance for doubtful accounts.

These examples make clear the comparison of ratios between years must be carefully performed. Use the following to help you understand expected changes in ratios:

For ratios that are greater than zero (i.e., positive):

1. Increasing the numerator of a ratio always increases the ratio.
2. Increasing the denominator of a ratio always decreases the ratio.
3. Increasing the numerator and denominator of a ratio by the same amount:
 - a. Decreases the ratio if the ratio is greater than 1.
 - b. Increases the ratio if the ratio is less than 1.⁸

⁸ To illustrate: (a) If the ratio is $4/3$ ($= 1.33$), increasing the numerator and denominator by 1 changes the ratio to $5/4$ ($= 1.25$). (b) If the ratio is $2/3$ ($= 0.67$), increasing the numerator and denominator by 1 changes the ratio to $3/4$ ($= 0.75$).

Timing of Analytical Procedures

Auditing standards require the application of analytical procedures at the *risk assessment* stage (usually done during audit engagement planning) and near the end of the audit. The auditors also may decide to use them during the audit as *substantive procedures* to provide evidence as to the reasonableness of the specific account balances.

Analytical procedures performed as risk assessment procedures are used to assist the auditors in determining the nature, timing, and extent of further audit procedures that will be used to obtain evidence about specific accounts. At the risk assessment stage, the objective of analytical procedures is to help the auditors identify unusual transactions, events, or amounts that indicate a heightened risk of material misstatement of the financial statements. Risk assessment analytical procedures also are used to increase the auditors' understanding of the client's business. During the risk assessment stage, auditors are required to perform analytical procedures relating to revenue to identify any unusual or unexpected relationships involving revenue accounts that may be indicative of fraud. For example, one procedure might be to compare revenue recorded by month during the current year with comparable prior years' revenue. Also, when auditing a client with seasonal sales fluctuations such as a toy distributor, the auditors would expect greater sales during the holiday season.

Analytical procedures may be used as substantive procedures to provide evidence about one or more financial statement assertions. While the auditors are not required to use substantive analytical procedures, they are usually the most efficient test of certain assertions. For example, performing analytical procedures often is the most efficient way to evaluate the completeness of various revenue and expense accounts. Chapters 10 through 16 illustrate the use of analytical procedures as substantive procedures for various types of financial statement accounts.

Finally, analytical procedures should be used near the end of the audit to assist the auditor in forming an overall conclusion on financial statements and in assessing the adequacy of the evidence that has been collected and the validity of the conclusions reached. At this stage, analytical procedures generally include reviewing the financial statements and notes and recomputing ratios (if necessary) to identify any unusual or unexpected balances or relationships that have not been previously identified and explained.

Extent of Analytical Procedures

Auditors should consider the cost and likely effectiveness of analytical procedures in determining the extent to which they will be used for a particular audit. While the cost is often low due to the availability of computers to perform computations and the simplicity of many procedures performed manually, the effectiveness of analytical procedures will vary from one audit to the next.

A primary measure of the effectiveness of an analytical procedure is its *precision*. Precision depends on a number of factors, including the predictability of the relationships, the technique used to develop the expectation, and the reliability of the underlying data used. If much "noise" exists in relationships between variables (e.g., sales and cost of goods sold), material differences might exist and not be identified by analytical procedures. Generally, precision can be improved by performing a more detailed analysis. For example, as indicated earlier, precision may be improved by performing analytical procedures with monthly rather than annual data.

The reliability and accuracy of the underlying data that are used for analytical procedures may be evaluated by considering the source of the data. If the client generated the data, the auditors will consider the controls applied to their development. In some cases, the auditor may have to apply audit procedures to the data to test their reliability before they are used in the analytical procedure.

Data Analytics

LO 5-5

Discuss the nature of data analytics and big data used in businesses and how they are used in auditing.

Data analytics, as used in businesses, may be viewed as the examination of large data sets to uncover hidden patterns, unknown correlations, market trends, customer preferences, and other useful business insights. We will begin with a discussion of general business applications of data analytics and then describe how the techniques are used in auditing.



Illustrative Case

UPS and Catalina Marketing

United Parcel Service (UPS) developed the means to track package movements and transactions as early as the 1980s. Subsequently, these tracking methods have been extensively enhanced as the company on a daily basis now tracks data on millions of packages. Much of these data are collected using scanning devices and sensors in vehicles. This allows UPS to collect data on deliveries, traffic and speed, direction, and drive train performance. The data are used not only to monitor daily performance, but also to drive a major redesign of UPS drivers' route structures. The program has led to substantial savings in fuel usage. In the future, one might expect driverless vehicles and drones that may lead to even more efficiency and effectiveness.

Catalina Marketing is a large shopper-driven marketing company that analyzes and predicts shoppers' buying behaviors for its clients. Catalina estimates that 80 percent of sales in a product or category are ordinarily made to 20 percent of potential customers. The company uses scanner data at retail grocery stores and pharmacies to better understand the nature of customers and to identify those 20 percent. Catalina representatives suggest that a deep analysis of sales in a product or category makes sense in that the goal is to identify the major customers for the various product lines and not waste resources on scattershot promotions across all customers. By identifying buyers' specific behaviors at the transaction level, such shopper-driven marketing can be more cost-effective than traditional mass marketing.

In businesses, data analytics have become increasingly important due to the proliferation of business data in recent years—a proliferation that has proven itself to be a challenge facing virtually every company, regardless of size. The data include traditional operational data within a company's accounting system that—through better data systems and databases—may be disaggregated and analyzed in more detail than in the past. For example, sales figures for particular time periods and sales outlets (e.g., sales online between the hours of 3:00 a.m. and 5:00 a.m.) may be accessed and analyzed. However, data also may be collected from many nonaccounting sources, such as employee inputs into smart devices and information from the Internet (e.g., Facebook, X (formerly Twitter), Instagram, and blogs).

These large databases are often referred to as **big data**—data that are extracted from extremely large traditional company databases as well as data from other sources. From a business perspective, it is a common belief that using regression and other multivariate analytical approaches to analyze these data results in better decision making. Data analytics techniques (including the use of **artificial intelligence**) often reveal important patterns, trends, and associations, especially those relating to human behavior and interactions. Currently, most business applications of data analytics are applied to enhancing operational efficiency and improving the effectiveness of marketing by obtaining a better understanding of the nature of customers and potential customers.

The integration of important data from differing sources into a workable form is often difficult. While a portion of the data is in a structured form within a database, much of the data are not. Also, even relatively structured data may be stored within disparate databases that historically have been difficult to integrate with one another. Additional difficulties with big data include issues related to (1) data accuracy and quality, (2) understanding what data are potentially useful, and (3) management and employee training on data analysis.

Application of Data Analytics to Auditing

Emerging electronic technologies offer both challenges and opportunities to auditors as they develop tools (referred to as **automated tools and techniques**) to use in their audits of clients using such technologies. In essence, analytical procedures as traditionally performed by auditors may be viewed as a basic form of data analytics. But the public accounting profession is in the process of integrating far more sophisticated audit data analytics. Indeed, technology, including artificial intelligence, is being used in auditing to

perform such procedures as counting inventories, inspecting fixed assets, handling confirmations, and reading and analyzing documents such as contracts and leases. Conceptually, the application of data analytical approaches may affect the audit in various ways, including approaches to risk assessment, tests of controls, and substantive procedures.

Data analytical approaches may be very useful in the performance of risk assessment. Such approaches allow the auditors to identify unusual relationships and trends that may be indicative of significant business or audit risks. For example, analysis of sales data by product line or type of sales or customer, using company data and social media data, may make it possible to identify sales anomalies that are indicative of significant risks. These risks may not be apparent from traditional analytical procedures that use more aggregated accounting and operational data. Although performing data analytic approaches in concept has always been possible, data limitations have often made it an inefficient approach. With automated data collection technology and integrated data sets, such analysis may be performed in seconds. Application of audit data analytics by its very nature results in a more detailed understanding of the client, and, accordingly, may assist auditors in the assessment of the risks of material misstatement.

Historically, auditors have performed tests of controls on samples of populations. As an example, auditors often have tested controls for approval of revenue transactions by examining a sample of transactions. Increasingly integrated databases make it possible and cost justified to test all of the transactions in a population. Available automated tools and techniques allow tests of databases and transaction files through use of queries that identify all items or transactions that are unapproved or unsupported. As another example, assume that a client's general journal entries reside in a number of databases, in varying systems, throughout a number of countries. If auditors are able to join or relate the entries in the various databases, it becomes possible to test all the entries for unusual characteristics. Audit software such as ACL and IDEA and proprietary software developed by the large CPA firms facilitate this testing.

Audit data analytics also can improve the effectiveness and efficiency of the auditors' substantive procedures. For example, it may be possible to substantiate a particular high-risk type of sale through use of data analytics to analyze detailed sales data, related warranty work, and returns and allowances data.

An automated technique may serve as both a risk assessment procedure and a substantive procedure. Consider our earlier example of analyzing sales data to identify sales anomalies indicative of significant risks. If the auditors determine that the audit data



Illustrative Case

AppZen

AppZen, a company that provides artificial intelligence (AI) technology for auditing and

spending reports, points out that AI allows auditors and/or the companies they audit to audit entire populations of accounts, such as employee spending and travel expense reports. Whereas manual audit tests of control and substantive procedures typically address the larger expenditures and a sample of the remainder, AI allows an audit of the entire population.

The company finds that over a variety of applications, on average AI flags 8.7 percent of expenses as high risk because they are recorded as unauthorized, are keyed in improperly, or are a duplicate expenditure. Another 4 percent of invoices are classified as high risk due to price, discount, or terms that don't

match the contract or market data. Also, note that AI may serve as an effective preventive control by identifying such transactions before payment is made.

AppZen reports identification of several very creative transactions including expenditures for a(n):

- Lunch with an oligarch.
- Strip club.
- Set of cufflinks.
- Private helicopter ride.
- Set of IT equipment at quintuple the market price.
- Automatically renewed contract for services that are no longer used.

analysis technique's results are significantly precise to respond to the assessed risks of material misstatement, that technique may serve both as a risk assessment procedure and as a substantive analytical procedure.

Throughout the text, particularly in the procedural Chapters 10 through 16, we provide additional illustrations of the use of audit data analytics.

Increased Use of Nonfinancial Data

Auditors are increasingly able to incorporate nonfinancial data into their data analysis. For example, online conversations may be useful to auditors. Consider a client with a relatively new technological product in which an estimate of returns and allowances must be made. Online conversations about a product may provide auditors with basic information on customers' beliefs about the reliability of the product, which may supplement information the auditors have received from management. It may also provide the auditors with insight about the adequacy of the accounting estimate for warranty expense.

Challenges and Risks of Audit Data Analytics

While effectively using data analytics and big data offers potential enhancements of the audit, it also involves a number of challenges and risks. All of the issues identified with management's use of data analytics apply to auditing, including disparate databases, data accuracy and quality, difficulties in identifying data that are useful, and limited skill levels of the audit staff.

Implementation of data analytics also requires a client-by-client approach by the auditors due to differences among client databases. Thus, while a company's task of integrating its data is a difficult one, auditors must address the issue repeatedly for multiple clients, each with differing methods of data organization. Certainly the auditors will obtain assistance both from their firm's own specialists and from the client. However, they also may encounter client resistance to providing certain data, for example, for security concerns. Additional challenges for the auditors include:

- On certain entire populations, the approach may not be appropriate and cost-justified. For example, complete audits of certain accounts or transactions may result in a great number of exceptions to a control, with a large number of the exceptions having little or no significance.
- Legal liability implications of auditing entire populations are uncertain. For example, what are the legal implications of going beyond the ordinary scope of the audit, yet missing a misstatement that it might be argued should have been identified with the expanded scope? Or is there potential legal liability when the scope is expanded for certain accounts, but not for others?

Even when effectively implemented, data analytics must not replace basic audit tenets such as the need to exercise professional judgment, including professional skepticism. In this regard, the managing partner of one large CPA firm stated:

I like to say I've never met a machine with courage and empathy, and that can read body language and adjust the response. It's really important that while we're going to get larger and larger volumes of data and information, the key part is to use these techniques to augment what the human does.

This new emphasis on data analytics leads to a major question: "Will all auditors need sophisticated data analytic skills?" While an auditor with a relatively high level of such expertise is likely to be a very valuable audit team member, it is not likely that such skills will be required by all auditors. Indeed, in today's environment, due to advances in technology, such procedures as downloading and combining data, performing sophisticated statistical techniques, and data mining are often performed by teams of specialists and third-party providers. However, it is clear that all audit teams will need to be able to use their knowledge of the client's business and operations and a high-level understanding of data analytics techniques to identify when and how such techniques can be effectively used. Therefore, we can expect that an understanding of the uses and limitations of data analytics techniques will increasingly become part of the required preparation of all auditors.

Audit Evidence for Subjective Areas

LO 5-6

Describe the considerations involved in auditing subjective areas, such as certain financial statement items valued at fair value and related party transactions.

Evidence Regarding Accounting Estimates

In this section we discuss accounting estimates (including estimates of fair values) and related party transactions. The nature of audit evidence in these areas merits special attention due to the subjectivity of judgments that need to be made by both management and the auditors.

Accounting estimates are made by management when financial statement monetary amounts cannot be directly observed. Examples include uncollectible accounts receivable, obsolete inventory, impaired long-term assets, financial investments that do not have organized markets, pensions, and warranty liabilities. While the amounts will generally be resolved in the future (e.g., the exact amount for uncollectible year-end accounts receivable), they are unknown at the time the financial statements are issued, thus requiring an estimate of the amount.

Accounting estimates involve using *methods* (which may include models), *assumptions*, and *data*. Accordingly, management makes an estimate by selecting a method, developing a combination of assumptions (implicit and explicit), and using data to apply that method. The degree to which accounting estimates are subject to **estimation uncertainty** varies substantially. For some estimates, uncertainty may be low based on their nature, and the complexity and subjectivity involved. To illustrate, consider inventory that is valued at the lower of cost or market. The estimation uncertainty for items that are currently being actively sold may be quite low because a rather precise measurement of market value may be available. In such a situation, the risk assessment procedures and further audit procedures may be limited. When estimation uncertainty is high, perhaps due to complexity, subjectivity, or both, such procedures would be more extensive. Indeed, in the extreme, an identified risk of material misstatement related to the accounting estimate may represent a **significant risk**.

While auditors apply professional skepticism throughout the audit, it is particularly important for accounting estimates due to the uncertainty involved. Accounts and disclosures for which there are a wide range of accounting methods considered acceptable are especially difficult to audit. Complicating the situation further, as we have discussed earlier in this chapter, is the fact that both management and auditor judgments related to estimates may be affected by biases. Management, for example, may bias its assumptions to produce more income due to a perceived need to meet an earnings goal. Auditor judgments may be affected by a tendency to anchor on management's estimates and to inappropriately weight confirmatory evidence more than contradictory evidence.

The professional standards (AICPA AU-C 540; PCAOB AS 2501) require the auditors to identify accounting estimates in significant accounts and disclosures, understand the manner in which estimates are developed, and respond to the risks of material misstatement. Responding to the risks of material misstatement involves evaluating whether the accounting estimates follow generally accepted accounting principles and are reasonable in the circumstances. This requires a knowledge of the client's business and the applicable generally accepted accounting principles.

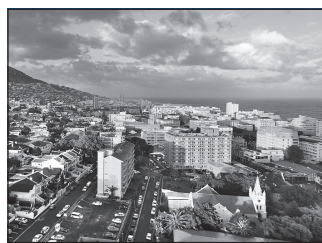
When evaluating the reasonableness of accounting estimates, the auditors obtain an overall understanding of how management developed the estimates and then use one or a combination of these three basic approaches:

1. *Review and test management's process of developing the estimates.* This involves performing procedures to test and evaluate the appropriateness and proper use of the methods, and the reasonableness of the **significant assumptions** and data used by the company to develop the estimates. This may be done by a combination of tests of controls and substantive tests. Similarly, when management has used information from external sources, the auditors evaluate those sources.

2. *Independently develop an estimate of the amount to compare to management's estimate.* This involves the auditors developing an independent estimate using appropriate methods, assumptions, and data. For example, if management has developed its warranty loss reserve using historical data about actual rates, the auditors might select a method that combines such historical data with industry data.
3. *Obtain evidence on relevant events or transactions occurring up to the date of the audit report.* This involves using transactions occurring through the date of the auditor's report to provide evidence about the reasonableness of the estimate. As an example, if the auditors are auditing an estimate of the warranty reserve liability for a product with a relatively short warranty period, the auditors might evaluate its reasonableness by examining warranty claims in the subsequent period (i.e., between the date of the financial statements and the completion of the audit).

The following illustrative case provides a summary of the manner in which auditors addressed warranty liability estimates, as summarized from the critical audit matters section of an audit report.

Recall from earlier in this chapter that auditors of public companies ("issuers") may ordinarily either assess the risk of material misstatement directly or make separate assessments of its components, inherent and control risk. Auditors of nonpublic companies should use the latter approach of separate inherent and control risk assessments when auditing accounting estimates. Chapters 10 through 16 present additional details on auditing accounting estimates in specific areas.



Illustrative Case

Example of a Critical Audit Matter (CAM) on Warranties

Malibu Boats Inc. designs, manufactures, and markets sport boats. The following excerpt

from KPMG's audit report on the company includes an abstract from the CAM:

EVALUATION OF CERTAIN ASSUMPTIONS UNDERLYING THE PRODUCT WARRANTY LIABILITY

Description:

As discussed in Note 9 to the consolidated financial statements, the Company's product warranty liability as of (year-end) was \$23.8 million. The product warranty liability represents estimated future costs to repair or replace defective products during the warranty period for each boat sold. The Company's estimated future costs to repair or replace defective products includes assumptions regarding the anticipated warranty costs per boat by brand. We identified the evaluation of the anticipated warranty costs per boat that are used to estimate the product warranty liability for . . . branded boats as a critical audit matter. A higher degree of subjective auditor judgment was required to evaluate the Company's estimate of the anticipated warranty costs per boat, due to the nature of the audit evidence.

Response:

The primary procedures we performed to address this critical audit matter included the following:

- We tested certain internal controls over the Company's warranty accrual process, including controls over the development of the assumptions used to estimate the warranty cost per boat for warranty years four and five, for which no historical claims experience exists.
- We performed sensitivity analyses to assess the impact of possible changes to these assumptions on the product warranty liability.
- We assessed the Company's historical claims experience and the relationship between the historical warranty costs per boat incurred in warranty year one compared to warranty year two, warranty year one compared to warranty year three, and warranty year two compared to warranty year three.
- We further assessed the Company's assumptions underlying the anticipated warranty costs per boat for warranty years four and five by considering warranty claims received after year-end but before the consolidated financial statements were issued, to identify trends not considered by the Company when it developed its assumptions.
- We also compared the Company's prior year product warranty liability related to claims expected to be incurred in the current year to actual claims received in the current year to evaluate the historical accuracy of the Company's estimates.

Auditor reporting on critical audit matters was introduced in Chapter 2 and is discussed in detail in Chapter 17.

Additional Considerations Relating to Accounting Estimates

A complicating factor in evaluating accounting estimates is that some methods may corroborate management's estimates while others contradict them. Earlier in this chapter we illustrated this through use of an example relating to the allowance for doubtful accounts in which an aging provided corroborative evidence while an examination of individual accounts provided potentially contradictory evidence. When this situation occurs and the risk of material misstatement is high, additional audit procedures should be performed.

Another complicating factor is that often even relatively small changes in significant assumptions may lead to large changes in the amount of the estimate. It is the auditors' responsibility to evaluate the relevance and reliability of assumptions and data used and whether the accounting rules followed are appropriate in the given circumstances. Frequently, auditors obtain assistance in evaluating estimates from specialists hired by management or the auditors.

As we have indicated, the subjective nature of accounting estimates makes it essential for auditors to be aware of the potential for management bias when evaluating the reasonableness of significant assumptions relating to the accounting estimate. Examples of significant assumptions include those that:

- Are sensitive to variation, such that small changes in the assumption cause significant changes in the estimate.
- Are susceptible to manipulation or bias.
- Involve unobservable data or company adjustments.
- Depend on the company's intent and ability to carry out specific courses of action.

To provide the auditors with evidence for evaluating potential management bias in current-period estimates, the auditors should perform a retrospective analysis of significant accounting estimates made in prior periods for evidence of bias in those estimates. Management bias or overall inaccuracy in prior estimates should seriously be considered in evaluating the current-period estimates.

The following illustrative case on deficiencies relating to auditing accounting estimates provides perspective on the audit work that should be performed related to the estimates.

Evidence Regarding Fair Values

In recent years, changes in accounting standards have required companies to significantly increase the use of accounting estimates of fair values for measuring, presenting, and disclosing various assets, liabilities, and components of equity. For example, fair values are used for various investments, intangible assets, impaired assets, and derivatives.

	Illustrative Case	Deficiencies Identified by PCAOB Inspection of Audits of Accounting Estimates 
PCAOB enforcement cases related to auditing accounting estimates have been relatively frequent, and have generally involved one or more of the following violations: 1. Failure to perform adequate procedures to determine the reasonableness of significant assumptions. 2. Failure to test the relevance, sufficiency, and reliability of the data supporting the accounting estimates. 3. Failure to sufficiently test the design and operating of controls over estimates and assumptions involving management review procedures. 4. Failure to perform a retrospective review of a significant accounting estimate to determine whether management's judgments and assumptions relating to the estimate indicated a possible bias. 5. Failure to adequately consider contradictory evidence or perform procedures to obtain corroboration for management representations regarding accounting estimates.		

In addition, financial accounting standards allow companies to voluntarily select fair value to determine the valuation for a number of financial statement items.⁹

Fair value is defined to be the price that would be received to sell an asset or the amount that must be paid to satisfy a liability in an orderly transaction between market participants at the measurement date. In auditing their clients' fair values, auditors should keep in mind that the goal is to achieve a fair value, as defined earlier in this paragraph, and to determine that valuation techniques¹⁰ are consistently applied, or, if revisions are needed, they are accounted for as a change in accounting estimate.

In developing fair values, management must select inputs for valuation methods in applying valuation techniques. FASB ASC 820-10, "Fair Value Measurement," provides the following three-level hierarchy related to valuation methods:

- Level 1: Inputs that involve observable quoted prices in active markets for identical assets or liabilities (e.g., a closing stock price listed in *The Wall Street Journal* for an investment).
- Level 2: Inputs that involve other observable quoted prices, generally for similar assets or liabilities in active markets (e.g., a company may discount the future cash flows of its not publicly traded debt securities at the rate used by the market for its publicly traded debt securities).
- Level 3: Inputs that are unobservable for the assets or liability (e.g., a private company uses judgment to determine a proper rate to discount the future cash flows of securities that are not publicly traded).

The hierarchy gives the highest priority to quoted prices in active markets (level 1) and lowest priority to unobservable inputs (level 3). Level 1 financial statement valuations often involve only very limited estimation uncertainty, while levels 2 and 3 involve increasingly higher levels of uncertainty.

The auditors should be alert for circumstances in which management may have an incentive to inappropriately characterize fair value measurements within the hierarchy. For example, a situation in which level 2 inputs are used may inappropriately be characterized by management in the notes to the financial statements as level 1 inputs. In addition, the auditors should determine that required disclosures are presented, including a description of the methods used to determine the amount.

In planning and performing audit procedures related to fair value measurements, the auditors should obtain an understanding of the company's process for determining fair value measurements and disclosures, including relevant controls. In addition, the auditors should

- Evaluate whether management's assumptions related to inputs are reasonable and if market information corroborates or contradicts management's assumptions.
- If management relies on historical financial information in the development of an input, consider the extent to which such reliance is justified.
- Evaluate whether the company's method for determining fair value measurements is applied consistently and, if so, whether the consistent application is appropriate given the current situation.

⁹ Those items include loans receivable and payable; investments in equity securities, including those using the equity method; rights and obligations under insurance contracts and warranty agreements; host financial instruments from embedded derivative instruments; firm commitments involving financial instruments; and written loan commitments.

¹⁰ The FASB presents three basic valuation techniques to establish fair value: market, income, and cost. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities (e.g., in the case of marketable securities, market value). The income approach uses valuation techniques to convert future amounts (e.g., cash flows or earnings) to a single discounted present value amount. The cost approach is based on the amount that would be required to replace the service capacity of an asset (this is a "replacement cost"). In some circumstances, a single valuation approach may be appropriate, while in others multiple techniques will be appropriate.

Fair value determination is easiest when there are published price quotations in an active market (e.g., a stock exchange). Determining fair value becomes more difficult when an active market does not exist: for example, in cases involving certain real estate investment properties and complex derivative financial instruments. In valuing assets that do not have active markets, fair value may be determined by analogizing to another existing market, or through the use of a valuation model (e.g., a model based on forecasts and discounting of future cash flows). These approaches are similar to those used for other estimates in that one or more of three approaches are used: (1) review and test management's process, (2) independently develop an estimate, or (3) review subsequent events through the date of the audit report.

When using the audit approach of reviewing management's process, the auditors test the client's controls over the development of the estimate. They should determine that the client's policies and procedures provide assurance that competent personnel are involved in developing the estimates, the assumptions used are reasonable, the valuation model is appropriate, and all relevant information is considered. The second approach, which involves developing the auditors' own estimate, offers the advantage of allowing the auditors to compare that estimate with the estimate developed by management. Often auditors will use a combination of these two approaches and also may decide to employ the assistance of a valuation specialist.

The third audit approach involves the use of information obtained subsequent to year-end to help evaluate the reasonableness of management's estimate. For example, the sale of an investment property shortly after the year-end may provide evidence of its value as of year-end. Yet, even in this situation, auditors should carefully consider the audit evidence because the sale might be impacted by circumstances that changed subsequent to year-end. For example, the prices of actively traded marketable securities that change after the year-end may not constitute appropriate evidence of values that existed at year-end. Regardless of the approach used, the auditors should evaluate whether the required disclosures related to fair values have been properly presented.

Evidence Regarding Related Party Transactions

How should auditors react if a corporation buys a parcel of real estate from one of its executive officers at an obviously excessive price? This situation illustrates the type of problem that may arise for auditors when the client company enters into **related party transactions**. Although certainly not always the case, related party transactions may involve terms and conditions that are not normal due to relationships among the involved related parties. Those related parties doing business with the client company may include officers, directors, principal owners, and members of their immediate families; and affiliated companies, such as subsidiaries. A related party transaction is any transaction between the company and these parties, other than normal compensation arrangements, expense allowances, and similar transactions arising in the ordinary course of business. Because transactions with related parties are not conducted at "arm's length," the auditors should be aware that the *economic substance* of these transactions might differ from their form. Related party transactions have often been used to facilitate fraudulent financial reporting. Accordingly, auditors should determine the business purpose of any **significant unusual transactions** (whether related party or not) that they encounter.

Even if the transactions are recorded appropriately, the auditors also must be concerned that material related party transactions are *adequately disclosed* in the client's financial statements or the related notes.¹¹

Disclosure of related party transactions should include the nature of the relationship; a description of the transactions, including dollar amounts; and amounts due to and from related parties, together with the terms and manner of settlement.

The primary challenge for the auditors is identifying any related party transactions that management has not disclosed because they may be recorded in the accounting

¹¹ FASB Accounting Standards Codification section 850-10, "Related Party Disclosures," contains requirements for disclosure of related party transactions.

records with all other transactions. Common methods of identifying related parties beyond inquiries of management include inquiries of others likely to have such information (e.g., internal auditors, legal counsel, the chief ethics officer, those charged with governance) and reviewing SEC filings, stockholders' listings, and *conflict-of-interest statements* obtained by the client from its executives. A list of all known related parties should be prepared at the beginning of the audit so that the audit staff may be alert for related party transactions throughout the engagement. This list is retained in the auditors' permanent file for reference and updating in successive engagements. Also, this list may include background information on the related parties such as physical location, industry size, and extent of operations. As they perform the audit, the auditors will be alert for transactions with these parties and for any significant unusual transactions. Examples of such include:

- Complex equity transactions such as corporate restructurings or acquisitions.
- Transactions with offshore entities in jurisdictions with less rigorous corporate requirements.
- Sales transactions with unusually large discounts or returns.
- Transactions with circular arrangements (e.g., a sale with a commitment to repurchase).

When unusual transactions are identified, the auditors should inquire of management about the nature of the transactions and whether related parties could be involved.

Auditors will also inquire concerning any unauthorized transactions with related parties and any exceptions to the company's established policies and procedures for such transactions, as well as the reasons for granting those exceptions. Also, unless all of those charged with governance are involved in management, the auditors should also inquire of them regarding their understanding of related party transactions and whether they have concerns regarding such transactions with related parties and, if so, the substance of those concerns.

The Public Company Accounting Oversight Board makes explicit in its standards that an audit should include obtaining sufficient appropriate audit evidence to obtain reasonable assurance that related parties, relationships, and transactions have been properly identified, accounted for, and disclosed in the financial statements. Also, auditors should emphasize the following in their audits:

- Relationships and transactions with related parties.
- Significant unusual transactions (with or without related party involvement).
- Financial relationships and transactions with executive officers.

Audit Documentation

LO 5-7

Describe the nature and purposes of audit documentation.

Audit documentation, also known as **working papers** or workpapers, is the record of the audit procedures performed, relevant audit evidence obtained, and the conclusions the auditors reach. Audit documentation may be recorded on paper or on electronic or other media.

AICPA AU-C 230 (PCAOB AS 1215) requires that audit documentation provide (1) evidence of the auditors' basis for concluding on the achievement of the audit's overall objectives and (2) evidence that the audit was planned and performed in accordance with GAAS. In addition to these primary objectives, audit documentation also serves the following functions:

- Assists both continuing audit team members and auditors new to the engagement in planning and performing the audit; as such, it also serves as a record of matters of continuing significance for future audits.
- Assists audit team members responsible for supervision in reviewing the quality of the work performed.

- Demonstrates the accountability of the various audit team members for the work performed.
- Assists (1) internal firm quality management (control) reviewers, (2) inspection or peer review individuals, and (3) successor auditors in performing their respective roles.

Audit working papers may take the form of bank reconciliations or analyses of ledger accounts; others may consist of copies of **minutes** of directors' meetings; still others might be organization charts or flowcharts of the client's internal control. Working trial balances, audit plans, correspondence (including e-mail) concerning significant matters, internal control questionnaires, letters or representations obtained from the client and from the client's legal counsel, and returned confirmation forms—all of these schedules, lists, notes, and documents are part of the auditors' audit documentation.

How detailed should documentation be? This depends on several factors, such as the nature of the auditing procedure being performed, the risk of misstatement involved in the area being tested, the significance of the evidence to the overall audit, the extent of judgment involved in performing the work, and the nature of the findings or results. The auditors should document all audit findings that they believe to be significant. In addition, audit documentation should be sufficient to allow an **experienced auditor** to understand the audit work performed, the evidence obtained, and the significant conclusions reached. In this context, an experienced auditor is one who possesses the competencies and skills to perform an audit of the client but who has had no previous experience with the client. The working papers also should demonstrate that the accounting records agree or reconcile to the financial statements being audited.

It is very important for the auditors to document audit findings or issues that are significant and the actions taken to address them. Such matters include the selection of appropriate accounting principles, accounting for complex and unusual transactions, and issues related to accounting estimates. Auditors also should document test results that indicate that the financial statements may be materially misstated, any significant difficulties encountered in applying auditing procedures, proposed audit adjustments, and findings that could result in a modification of the audit report. Finally, audit documentation should identify those who performed and reviewed the work and the related dates of performance.

Confidential Nature of Working Papers

To conduct a satisfactory audit, the auditors must be given unrestricted access to all information about the client's business. Much of this information is confidential, such as the profit margins on individual products, tentative plans for business combinations with other companies, and the salaries of officers and key employees. Officers of the client company would not be willing to make available to the auditors information that is restricted from competitors, employees, and others unless they could rely on the auditors' maintaining a professional silence on these matters.

Much of the information gained in confidence by the auditors is recorded in their working papers; consequently, the working papers are confidential in nature. The AICPA *Code of Professional Conduct* includes a rule that generally prohibits a member in public practice from disclosing confidential information.

Under normal circumstances, auditors think of confidential information as being information that must not be divulged *outside* the client organization. But the confidential nature of information in the auditors' working papers has another dimension: Often it must not be divulged *within* the client organization. If, for example, the client does not want certain employees to know the levels of executive salaries, the auditors obviously should not defeat this policy by exposing their working papers to unauthorized client personnel. Also, the working papers may identify particular accounts, branches, or time periods to be tested by the auditors; to permit the client's employees to learn of these in advance would weaken the reliability of the results of the tests.

Because audit working papers are highly confidential, they must be safeguarded at all times. Safeguarding working papers usually includes keeping them, or the computers accessing them, locked away or password protected.

Ownership of Audit Working Papers

Audit working papers are the *property of the auditors*, not of the client. At no time does the client have the right to demand access to the auditors' working papers. After the audit, the working papers are retained by the auditors.

Clients may sometimes find it helpful to refer to information from the auditors' working papers from prior years. Auditors usually are willing to provide this information, but their working papers should not be regarded as a substitute for the client's own accounting records. The Acts Discreditable Rule of the AICPA *Code of Professional Conduct* explains the ethical requirements related to auditor working papers and client records.

Working Papers and Auditors' Liability

The **audit file** includes the working papers for a particular engagement and is the principal record of the work performed during the audit. If the auditors are subsequently charged with negligence, the working papers included in the audit file will be a major factor in refuting or substantiating the charge. Although properly prepared audit documentation will help the auditors should litigation follow, improperly prepared documentation will work against them.

If a lawsuit is brought against the auditors, the plaintiffs will subpoena the audit documentation and analyze it in great detail, looking for contradictions, omissions, or any evidence of carelessness or fraud. This possibility suggests the need for public accounting firms to make their own critical review of the documentation at the end of each engagement. During this review, the auditors should bear in mind that any unexplained contradictory statements may be used at a later date to support a charge of improper auditing.

How long should audit documentation be retained? The professional standards require a period of not less than five years, while the Sarbanes–Oxley Act of 2002 requires that auditors maintain documentation for seven years. Thus, for public clients, auditors must retain working papers for seven years, but they may destroy them after five years if the client is a nonpublic company.

Changing Audit Documentation after the Date of the Audit Report

Auditors of nonpublic company clients are given 60 days after the audit **report release date** (the date the client is granted permission to use the report) to complete the audit file by assembling a complete and final set of audit documentation.¹² During this period, they are able to perform routine file-assembling procedures such as deleting or discarding superseded documentation and sorting, collating, and cross-referencing final working papers. In addition, they may sign off on various checklists and add information received subsequent to the date of the auditors' report (e.g., receipt of a hard-copy confirmation that was previously orally confirmed as a part of alternate procedures performed when hard copy had not been received). The updated or revised audit documentation should contain all of the information, evidence, and conclusions that were in any superseded documentation. However, if certain information is no longer relevant or valid, it may be discarded during this 60-day period.¹³ After the close of this 60-day period, referred to as the **documentation completion date**, no information may be discarded from audit working papers.

If new information is added to the working papers after the issuance of the audit report—either before or after the documentation completion date—documentation should include (1) when and by whom changes were made and reviewed; (2) specific reasons for the changes; and (3) the effect, if any, of the changes on the auditors' conclusions.

Differences of Opinion

On occasion, inconsistencies will arise in the working papers because different members of the audit staff—say, a senior and the engagement partner—reach different conclusions

¹² Public Company Accounting Oversight Board *Standard No. 3*, "Audit Documentation," allows only a 45-day period for publicly traded clients.

¹³ See Chapter 16's section on "Post-Audit Responsibilities" for additional auditor responsibilities when it is discovered that an important audit procedure was omitted or that facts existing at the date of the balance sheet were not appropriately considered.

on some complex auditing or accounting issue. In such cases, the disagreeing auditors should discuss the matter to see if they can reach agreement. If they are able to do so, the working papers should be revised to reflect their common opinion. If they are not able to reach agreement, the opinion of the partner-in-charge of the engagement will prevail with respect to the content of the auditors' report. However, all other members of the audit team have the right to document in the working papers *their disagreement* with the ultimate decision. In the event that a staff person elects to document their disagreement, the partner-in-charge obviously should be extremely thorough in documenting the rationale underlying the firm's ultimate decision in a carefully written memorandum. The SEC interprets the Sarbanes–Oxley Act of 2002 as requiring that working papers be retained regardless of whether they support or are inconsistent with the auditors' final conclusion relating to significant matters. However, the act does not require retention of preliminary views when those preliminary views are based on incomplete information or data.

Types of Working Papers

Because the audit working papers document a variety of information gathered by the auditors, there are numerous types of working papers. However, there are certain general categories into which most working papers may be grouped. These are (1) audit administrative working papers; (2) working trial balance and lead schedules; (3) adjusting journal entries and reclassification entries; (4) supporting schedules, analyses, reconciliations, and computational working papers; and (5) corroborating documents.

Audit Administrative Working Papers

Auditing is a sophisticated activity requiring planning, supervision, control, and coordination. Certain working papers are specifically designed to aid the auditors in the planning and administration of engagements. These working papers include audit plans, work programs or audit programs, internal control questionnaires and flowcharts, engagement letters, and time budgets. Memoranda of the planning process and significant discussions with client management are also considered **administrative working papers**.

Working Trial Balance

The **working trial balance** is a schedule listing the balances of the accounts in the general ledger for the current and previous year and also providing columns for the auditors' proposed adjustments and reclassifications and for the final amounts that will appear in the financial statements. A working trial balance, ordinarily an electronic spreadsheet, is the "backbone" of the entire set of audit working papers; it is the key schedule that controls and summarizes all supporting papers. A portion of a working trial balance is shown in Figure 5.6.

FIGURE 5.6 Working Trial Balance Abstract

Process Company, Inc. Working Trial Balance For the Period Ended December 31, 20X5					Prepared by ATT Reviewed by RBS Page 1	
Account #	Account Name	Prior Period Balance 12/31/X4	Unadjusted Trial Balance		Adjustments DR (CR)	Balance Sheet DR (CR)
			DR (CR)	Ref #		
100.101	Cash	398,743	481,413			481,413
1010.01	Short-Term Investments		167,89			167,890
1040.01	Accounts Receivable	2,053,914	2,298,722			2,298,722
1045.01	Allowance for Doubtful Accounts	(45,325)	(56,984)	AJE-11	(10,456)	(67,440)
1050.01	Inventories	2,567,665	2,701,814	AJE-12	(129,799)	2,572,015

In many audits, the auditors download a client's working trial balance into their software after all normal end-of-period journal entries have been posted. Before accepting the trial balance for their working papers, the auditors should compare the amounts to the general ledger to determine that the trial balance is prepared accurately; this procedure often is performed electronically.

Lead Schedules

Separate **lead schedules** (also called *grouping sheets* or *summary schedules*) are set up to combine similar general ledger accounts, the total of which appears on the working trial balance as a single amount. For example, a lead schedule for Cash might be a spreadsheet that combines the following general ledger accounts: Petty Cash, \$500; General bank account, \$196,240; Factory Payroll bank account, \$10,000; and Dividend bank account, \$1,000. Similar lead schedules would be set up for Accounts Receivable, Inventories, Stockholders' Equity, Net Sales, and other balance sheet or income statement components.

Adjusting Journal Entries and Reclassification Entries

During the course of an audit engagement, the auditors may discover various types of misstatements in the client's financial statements and accounting records. These misstatements may be large or small in amount; they may arise from the omission of transactions or from the use of incorrect amounts; or they may result from improper classification or **cutoff**, or from misinterpretation of transactions. Generally, these misstatements are accidental errors; however, the auditors may find them to be the result of fraud.



Throughout the audit, the auditors accumulate the misstatements identified (other than those regarded as clearly trivial) and propose appropriate **adjusting journal entries (AJEs)**. In addition, the auditors develop **reclassification journal entries (RJE)**s for items that, although correctly recorded in the accounting records, must be reclassified for fair presentation in the client's financial statements. For example, accounts receivable with large *credit* balances should be *reclassified* as a liability in the balance sheet. Reclassification entries affect only the financial statement presentation; therefore, they are *not recorded* in the client's accounting records. Reclassification entries appear only on accounting worksheets.

As is discussed in detail in Chapter 16, near the conclusion of the audit the auditors consider whether uncorrected misstatements, either individually or in the aggregate, plus an allowance for undetected misstatements are less than a **material** amount. As this total approaches a material amount, additional audit procedures or audit report modifications should be considered. In making this judgment, auditors must consider both qualitative characteristics of misstatements and adequacy of financial statement disclosures.

Supporting Schedules

Although all types of working papers may loosely be called schedules, auditors prefer to use this term to describe a listing of the elements or details comprising the balance in an asset or liability account at a specific date. Thus, a list of amounts owed to vendors making up the balance of the Trade Accounts Payable account is properly described as a *schedule*.

Analysis of a Ledger Account

An analysis of a ledger account is another common type of audit working paper. The purpose of an analysis is to show *the changes* in an asset, liability, equity, revenue, or expense account during the period covered by the audit. If a number of the changes are individually immaterial, they may be recorded as a single item in the analysis working paper. Account analyses are most useful in substantiating those accounts affected by relatively few transactions during the year. Examples include plant asset accounts, long-term debt accounts, capital stock accounts, and retained earnings.

To analyze a ledger account, the auditors first list the beginning balance and indicate the nature of the items comprising this balance. Next, the auditors list and investigate

the nature of all debits and credits to the account during the period. These entries, when combined with the beginning balance, produce a figure representing the balance in the account as of the audit date. If any misstatements or omissions of importance are detected during this analysis of the account, the necessary adjusting journal entry approved by the client is entered on the working paper to produce the adjusted balance required for the financial statements.

Reconciliations

Frequently, auditors wish to prove the relationship between amounts obtained from different sources. When they do so, they obtain or prepare working papers known as reconciliations. These reconciliations provide evidence as to the accuracy of one or both of the amounts and are important to the audit of many accounts, including cash, accounts receivable, and inventories.

Computational Working Papers

Another type of supporting working paper is the computational working paper. The auditors' approach to verifying certain types of accounts and other figures is to make an independent computation and compare their results with the amounts shown by the client's records. Examples of amounts that might be verified by computation are interest expense, depreciation, payroll taxes, income taxes, pension liabilities, and earnings per share.

Corroborating Documents

Auditing is not limited to the examination of financial records, and working papers are not confined to schedules and analyses. During the course of an audit, the auditors may gather expository material to substantiate their report. One common example is copies of minutes of directors' and stockholders' meetings. Other examples of **corroborating documents** include copies of articles of incorporation and bylaws; copies of important contracts, bond indentures, and mortgages; memoranda pertaining to examination of records; audit confirmations; and representation letters from the client and from the client's legal counsel.

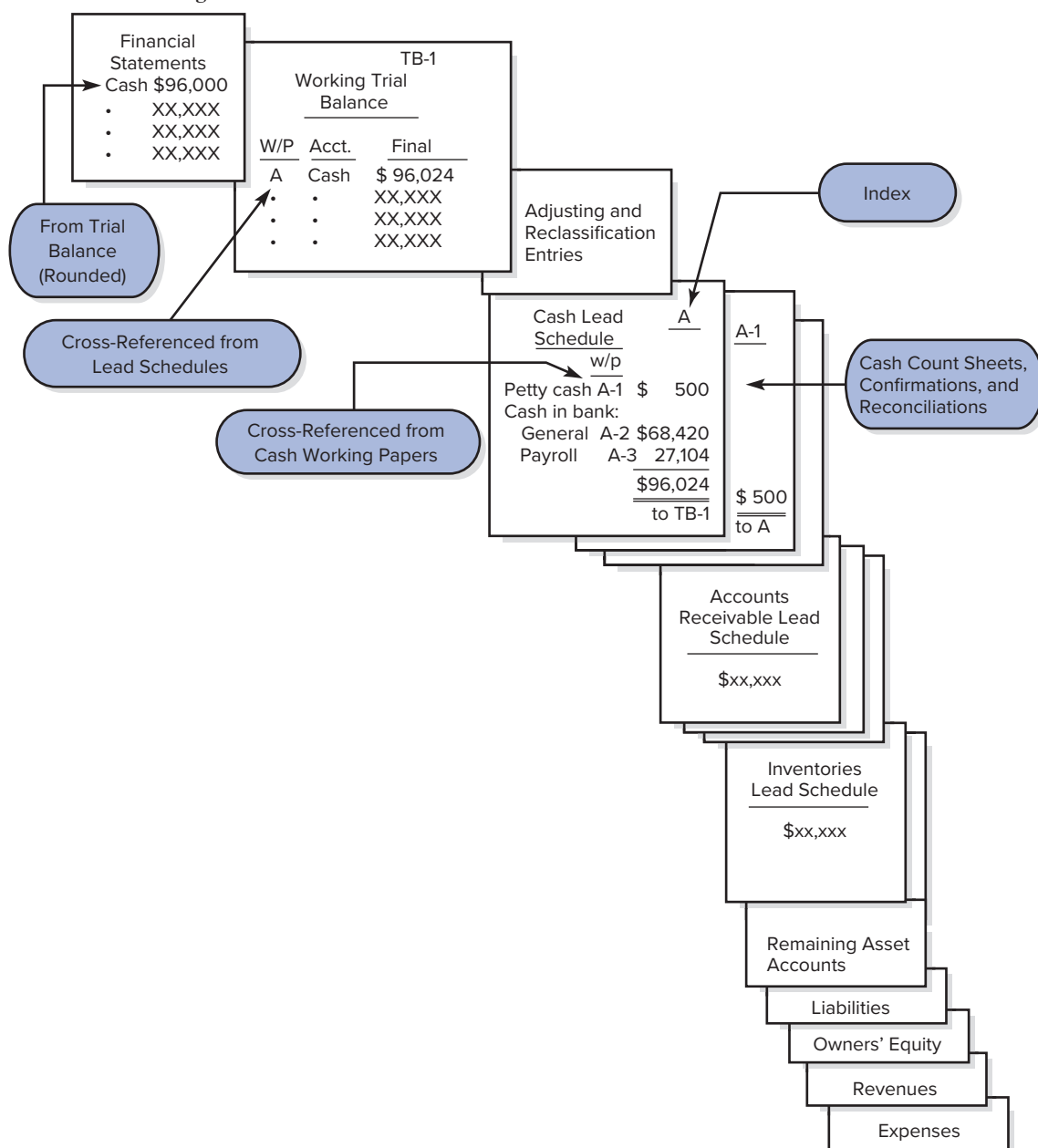
Organization of Working Papers

The auditors usually maintain two files of working papers for each client: (1) current files for every completed audit and (2) a permanent file of relatively unchanging data. The current file (as for the 20X0 audit) pertains solely to that year's audit; the permanent file contains such items as copies of the articles of incorporation, which are of continuing audit interest.

The Current Files

The auditors' report for a particular year is supported by the working papers contained in the current files. Many CPA firms have found it useful to organize the current files around the arrangement of the accounts in the client's financial statements. The administrative working papers usually begin the current files, including a draft of the financial statements and the auditors' report. These working papers are followed by the working trial balance and the adjusting and reclassification entries. The remaining portion of the current files consists of working papers supporting the balances and other representations in the client's financial statements. It begins with working papers for each asset account and continues with papers for liabilities, owners' equity accounts, and revenue and expense accounts.

Each working paper in a file is assigned an index number, and information is tied together through a system of cross-referencing. In this way, a reviewer may trace back amounts on the working trial balance to the supporting working papers. The current files tend to be stored on a shared platform such as SharePoint or a proprietary firm software that allows members of the engagement team to work on different sections of the audit and different working papers simultaneously and synchronizes the files in the electronic file management system. Figure 5.7 illustrates a system of cross-referencing and a typical arrangement of the current files after the administrative working papers.

FIGURE 5.7 Organization of the Current Files

The Permanent File

The **permanent file** serves three purposes: (1) to refresh the auditors' memories on items applicable over a period of many years; (2) to provide new staff members with a quick summary of the policies and organization of the client; and (3) to preserve working papers on items that show relatively few or no changes, thus eliminating the necessity for their preparation year after year.

Much of the information contained in the permanent file is gathered during the course of the first audit of a client's records. A considerable portion of the time spent on a first audit is devoted to gathering and appraising background information, such as copies of articles of incorporation and bylaws, leases, patent agreements, pension plans, labor contracts, long-term construction contracts, known related parties, charts of accounts, and prior years' tax returns.

Analyses of accounts that show few changes over a period of years are also included in the permanent file. These accounts may include land, buildings, accumulated depreciation,

	Illustrative Case	Audit Documentation Issues
Lack of documentation is a continuing issue in peer review findings. Recent AICPA reports indicate the following recurring deficiencies regarding audit documentation: • Failure to adequately document key audit areas. • Failure to adequately document key elements of the understanding obtained regarding each of the aspects of the client and its environment, including each of the components of internal control and the sources of information from which the understanding was obtained. • Failure to document the assessment of the risks of material misstatement. • Failure to document the overall responses to the assessed risks of material misstatement. • Failure to adequately document the performance of analytical procedures, especially the expectations developed. • Failure to adequately document the audit procedures performed. Electronic audit working papers tend to decrease these deficiencies by forcing consistency of performance and review by the audit team.		

long-term investments, long-term liabilities, capital stock, and other owners' equity accounts. The initial investigation of these accounts must often include the transactions of many years. Once these historical analyses have been brought up to date, the work required in subsequent examinations will be limited to a review of the current year's transactions in these accounts. In this respect, the permanent file is a time-saving device because current changes in such accounts need only be added to the permanent papers without reappearing in the current working papers. Adequate cross-referencing in the working papers, of course, should be provided to show where in the permanent file such information can be found.

Guidelines for Preparation of Working Papers

We will now summarize in a few short paragraphs our basic guidelines for preparing working papers that will meet current professional standards.

A separate, properly identified working paper should be prepared for each topic. Proper identification of a working paper is accomplished by a heading that includes the name of the client company, a clear description of the information presented, and the applicable date or the period covered. If the working paper was prepared by the client's staff, it should be labeled "PBC" (prepared by client) and appropriately tested.

Complete and specific identification of documents examined, employees interviewed, and sites visited is essential for good working paper practice. The preparer of a working paper should date and sign or initial the working paper; the signatures or initials of the senior, manager, or partner who reviewed the working paper also should appear on the paper. Electronic working papers automatically keep track of dates, preparers, and reviewers.

Working papers should be appropriately referenced and cross-referenced to the working trial balance or relevant lead schedule. Where reference is necessary between working papers, there should be adequate cross-referencing, now often in the electronic form of hyperlinked documents.

The nature of verification work performed by the auditors should be clearly indicated on each working paper. A review of paid purchase invoices, for example, might be supplemented by inspection of the related purchase orders and receiving documents to substantiate the authenticity of the invoices examined; a description of this verification procedure should be included on the working paper. As audit working papers are prepared, the auditors will use several different symbols to identify specific steps in the work performed. These symbols, or **tick marks**, either manually written or electronically inserted, provide a very concise means of indicating the audit procedures applied to particular amounts. Whenever tick marks are employed, they should be accompanied by a legend explaining their meaning.

The working papers should include comments by the auditors indicating their conclusions on each aspect of the work. In other words, the auditors should clearly express the opinion they have formed as a result of having performed the audit procedures summarized in the working paper. Figure 5.8 illustrates such a conclusion related to the audit of the allowance for uncollectible accounts, along with other aspects of a properly prepared working paper.

FIGURE 5.8 Preparation of a Working Paper

Working Paper Heading	Reviewer's Initials and Date	Preparer's Initials and Date	Index
Maine Company, Inc. Allowance for Uncollectible Accounts March 31, 20X3			
Balance per ledger, Mar. 31, X2			22,881.75 ✓
Deduct: Write-offs during fiscal 20X3 June 18, X2 Morgan Desk Co. Feb. 12, X3 Baker Cabinet Co.		6,581.44 n <u>8,041.60 n</u>	14,623.04 8,258.71
Add: Provision for year ended Mar. 31, X3, based on aged trial balance of trade accounts receivable at Mar. 31, X3			6,589.81
Balance per ledger, Mar. 31, X2			14,848.52 ✓
A.J.E. 7 — to increase allowances based on tests of collectibility and analytical procedures on C-6		5,151.48 to TB-5-2	
Adjusted balance Mar. 31, X3			<u>20,000.00</u> f to C
f Footed. n Examined Controller's authorization for write-off. ✓ Agreed to general ledger.			
Auditors' Conclusion → Based on the results of the tests of collectibility and analytical procedures on C-6, the adjusted balance of the allowance for uncollectible accounts appears to be adequate to value the accounts receivable at net realizable value.			
		B.J.D. V.M.A.	

Maine Company, Inc. Adjusting Journal Entries March 31, 20X3			TB-5-2 V. M. A 4/26/X3	
Working Paper Reference	Account No.	Account Title and Explanation	Dr.	Cr.
C-5	524	Uncollectible Accounts Expense	5,151.48	
	126	Allowance for Uncollectible Accounts		5,151.48
To increase the allowance for uncollectible accounts to amount considered necessary based on test work performed.				

Computer-Generated Working Papers

Traditionally, working papers have been prepared in pencil on columnar paper. Today, most working papers are prepared on electronic devices carried by the auditors to the work site. When an adjustment is entered on computer-based working papers, it appears instantly on the appropriate lead schedules, the adjustments schedule, and the working trial balance. The necessary cross-references are automatically entered on each schedule. If the adjustment affects taxable income, the income tax expense account and the tax liability are automatically adjusted using the client's marginal tax rate. In addition, all the subtotals, column totals, and cross-footings in the working papers are instantly adjusted.

Most CPA firms make full use of the document scanning, data linking, networking, and telecommunications capabilities of personal computers. These firms can produce numerous electronic working papers, creating a nearly "paperless audit." Firms also employ an electronic file management system to store the current-year client files. These systems may be proprietary or may include commercial file management systems. As auditors complete their work, they may sync their workpapers to the electronic file management system and their work becomes instantly available to the senior associates and managers for their review.

Review of Audit Working Papers

Working papers are reviewed at every supervisory level of a CPA firm. Senior auditors review the working papers of staff assistants; managers review all working papers prepared by staff assistants and by senior auditors; the partner in charge of the engagement reviews the entire set of working papers. Many CPA firms also require a review by a second partner as part of the firm's quality procedures.

What Do Reviewers Look For?

All reviewers look to see that the working papers properly document the audit. However, there are differences in the nature of the reviews. The senior's review is the most technical, and it generally is performed promptly after the completion of the individual working paper. Seniors look primarily to see that the staff assistant has performed the audit procedures properly and that the assistant's findings and conclusions are logical and clearly expressed.

The reviews by managers and partners are often performed near the *end* of the engagement, when the reviewer may examine at one time the entire set of working papers. These reviewers are primarily interested in determining that the audit was performed in accordance with generally accepted auditing standards and that the working papers properly support the auditors' report that will be issued on the financial statements. There are several advantages to reviewing all of the working papers at once. The reviewer can determine that the working papers "tie together"—that is, that information is properly carried forward from one working paper to another. The possibility of a problem in this area is significantly reduced with the use of electronic working papers.

As described earlier in the chapter, reviewers also look critically for any inconsistencies, omissions, or "loose ends" that might later support a plaintiff's allegations of improper auditing. In addition, the reviewer should consider whether the various immaterial discrepancies that were passed without adjustment might *cumulatively* have a material effect upon the financial statements.

The purposes of a *second partner review* are to provide assurance that all the CPA firm's in-house *quality policies* have been complied with, as well as to provide a "second opinion" that the audit was performed in accordance with generally accepted auditing standards. The second partner review, sometimes called a *quality review* or a *cold review*, usually is performed by a partner with no personal or professional ties to the audit client. Multioffice CPA firms sometimes bring in a partner from another office to perform

the second partner review. Not until all these reviewers have “signed off” on the audit working papers is the CPA firm’s name signed to the auditors’ report. A second partner engagement quality review is required under PCAOB standards.

Chapter Summary

This chapter focused on the concept of sufficient appropriate audit evidence and the manner in which this evidence is documented in the audit working papers. To summarize:

1. Auditing standards require the auditors to obtain sufficient appropriate audit evidence to support their audit opinion. Sufficiency is the measure of the quantity of the evidence. Appropriateness of evidence relates to its relevance and its reliability in providing support for or detecting misstatements in account balances, transactions, and disclosures. Sufficiency and appropriateness are interrelated and lead to audit decisions on the *nature* of audit evidence that is collected, its *timing*, and its *extent*.
2. Auditing standards require auditors to exercise professional skepticism which includes applying a questioning mindset and being aware of the potential for conscious and unconscious bias. Auditors must consider if their professional judgment is subject to anchoring, confirmation, overestimation, automation, or availability bias.
3. Audit evidence is gathered by the auditors to reduce audit risk—the risk that the auditors may issue an inappropriate opinion on financial statements that are materially misstated. Because financial statements consist of a series of assertions by management, the auditors should obtain sufficient appropriate audit evidence about each significant financial statement assertion.
4. Audit risk consists of (a) the risk of material misstatements in the financial statements and (b) the risk that the auditors will not detect such misstatements. A major portion of the audit involves obtaining evidence about relevant assertions, which are those assertions with a reasonable possibility of being materially misstated before considering controls. Auditors must obtain sufficient appropriate audit evidence that all relevant assertions are not materially misstated. Relevant assertions with a *very high* likelihood of misstatement and a very high magnitude of potential misstatement are referred to as significant risks.
5. In considering risks of material misstatement, the profession’s standards consider them as existing at two levels: (a) the financial statement level and (b) the assertion level for classes of transactions, account balances, and disclosures. At the assertion level, the risk of material misstatement is composed of inherent risk and control risk. Detection risk is the risk that the auditors’ procedures will not detect a material misstatement.
6. Substantive procedures include tests of details and analytical procedures. Tests of details ordinarily involve testing support for recorded account balances, transactions, and disclosures. Substantive analytical procedures provide evidence about account balances, transactions, and disclosures through analyzing relationships among data. Analytical procedures also are performed to assist the auditor in risk assessment and as an overall review of the financial information near completion of the audit.
7. Increasingly, auditors are using data analytics approaches, which use automated tools and techniques to plan and perform the audit. These procedures may affect risk assessment, tests of controls, and substantive procedures. One significant effect of the implementation of audit data analytics is the ability to efficiently audit entire populations of transactions for particular characteristics.
8. Auditors should be especially careful in considering financial statement accounts that are affected by estimates made by management, such as the allowance for doubtful accounts. The inherent risk of these types of accounts is generally much greater than for other financial statement accounts.

9. Audit documentation is the connecting link between the client's accounting records and the auditors' report. Such documentation is the property of the auditors and is primarily used to demonstrate the auditors' compliance with professional standards and to support the auditors' opinion. Other functions of audit documentation include providing assistance in planning and performing the audit, facilitating supervision and review of audit work, providing a record of matters relevant to future audits, enabling other auditors to conduct peer reviews and inspections, and assisting successor auditors.

Key Terms Introduced or Emphasized in Chapter 5*

Accounting estimates (186) Approximations used in a company's financial statements when there is an inherent lack of precision of measurement (estimation uncertainty). These approximations rely upon management's judgments or assumptions, such as determining the allowance for doubtful accounts, establishing warranty reserves, and assessing assets for impairment. We will consider the term *estimation uncertainty* synonymous with the term *measurement uncertainty*.

Adjusting journal entries (AJEs) (195) Journal entries designed to correct misstatements found in a client's records.

Administrative working papers (194) Working papers specifically designed to help the auditors in the planning and administration of the engagement, such as audit plans, internal control questionnaires and flowcharts, time budgets, and engagement memoranda.

Appropriate audit evidence (160, 166) A measure of the quality of the evidence, that is its relevance and reliability. Appropriate audit evidence is information that is both relevant and reliable in providing support for the conclusions on which the auditor's opinion is based.

Artificial intelligence (AI) (183) The theory and development of computer systems able to perform tasks that normally require human intelligence. General examples of such tasks include visual perception, speech recognition, decision making, and translation between languages. In an auditing context, electronically performing various analyses historically performed by humans is hoped to increase both the efficiency and quality of audits.

Assertions (160) Representations, explicit or otherwise, with respect to the recognition, measurement, presentation, and disclosure of information in the financial statements, which are inherent in management, representing that the financial statements are prepared in accordance with the applicable financial reporting framework. Assertions are used by the auditor to consider the different types of potential misstatements that may occur when identifying, assessing, and responding to the risks of material misstatement.

Audit data analytics (169) The analysis of patterns, identification of anomalies, or extraction of other useful information in data underlying or related to the subject matter of an audit through analysis, modeling, or visualization.

Audit evidence (160) The information used by auditors in arriving at conclusions on which the audit opinion is based. Audit evidence is information to which audit procedures have been applied and consists of both information that corroborates (supports) management's assertions regarding the financial statements and information that contradicts such assertions.

Audit file (193) The unit of storage for a specific audit engagement. The audit documentation for each year's audit of a company is included in its audit file.

Audit risk (160) The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.

Automated tools and techniques (183) As used in auditing, this includes both (1) automated audit tools (e.g., audit data analytics) and (2) automated techniques (e.g., artificial intelligence, robotic process automation, and blockchain).

Big data (183) As applied in business, large data sets containing a variety of data types (i.e., big data) that are analyzed to uncover hidden patterns, unknown correlations, market trends, customer preferences, and other useful business information. These data sets are so large and complex they require new and powerful computational resources to process them. While big data may include traditional accounting information, it also may include other data such as: GPS data, videos, social media data, e-mails, and website hits.

* Note: Figure 5.3 defines a number of audit procedures. Those terms are not repeated in this glossary.

Cognitive biases (167) Systematic errors in thinking that affect the decisions and judgments that people make. Many of these are caused by the tendency for the human brain to perceive information through a filter of personal experience and preferences.

Common-size financial statements (179) Financial statements that present each amount as a percentage of some financial statement base. As an example, a common-size income statement presents all revenues and expenses as a percentage of net sales. See *vertical analysis*.

Control risk (163, 164) The risk that a material misstatement could occur in a financial statement assertion and not be prevented, or detected and corrected, on a timely basis by internal control.

Corroborating documents (196) Documents and memoranda included in the working papers that substantiate representations contained in the client's financial statements. These working papers include audit confirmations, lawyers' letters, copies of contracts, copies of minutes of directors' and stockholders' meetings, and representation letters from the client's management.

Critical audit matter (173) As included in the PCAOB auditing standards, a matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment.

Cross-sectional analysis (179) A technique that involves comparing the client's ratios for the current year with those of similar firms in the same industry.

Cutoff (195) The process of determining that transactions occurring near the balance sheet date are assigned to the proper accounting period.

Data analytics (182) Analyses applied to raw data with the purpose of drawing conclusions about relationships. Data analytics is being used by management to get insights into how to improve the effectiveness and efficiency of operations. It is also used as a part of the management review to monitor the performance of other internal controls. Auditors are increasingly using data analytics to improve the effectiveness of certain audit procedures.

Date of the auditor's report (172) The date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements or other financial information being reported upon. The audit report is ordinarily dated as of this date.

Detection risk (164) The risk that the auditors' procedures will lead them to conclude that a financial statement assertion is not materially misstated when in fact such misstatement does exist.

Documentation completion date (193) The date on which audit documentation should be completed. This is within 60 days (45 days for public companies) from the audit report release date.

Electronic data interchange (EDI) (171) A computer network between companies that allows the interchange of data from one company's computer to the other's (e.g., allows purchases and sales between two firms to be processed electronically).

Estimation transaction (163) A transaction involving management's judgments or assumptions, such as determining the allowance for doubtful accounts, establishing warranty reserves, and assessing assets for impairment.

Estimation uncertainty (186) Susceptibility to an inherent lack of precision in measurement. Also referred to as measurement uncertainty.

Experienced auditor (192) For purposes of audit documentation, an individual who has *practical audit experience* and a reasonable understanding of (1) audit processes, (2) *Statements on Auditing Standards* and applicable legal and regulatory requirements, (3) the business environment in which the entity operates, and (4) auditing and financial reporting issues relevant to the entity's industry. Having *practical audit experience* is equivalent to possessing the competencies and skills that would have enabled the experienced auditor to perform the audit.

External information source (166) An external individual or organization that provides information that is used by the entity in preparing the financial statements, or that provides information used by the auditors as audit evidence. Information provided by management's or the auditors' specialists or a service organization is not considered an external information source with respect to that particular information.

Further audit procedures (176) The additional procedures that are performed based on the results of the auditors' risk assessment procedures. Further audit procedures include tests of controls and substantive procedures, including (1) tests of details of account balances, transactions and disclosures and (2) substantive analytical procedures.

Horizontal analysis (179) A technique that involves comparing financial statement amounts and ratios for a particular company from year to year.

Inherent risk (163) The risk of material misstatement of a financial statement assertion before considering any related controls. Inherent risk may increase due to qualitative and quantitative inherent risk factors.

Qualitative inherent risk factors relating to the preparation of financial statements may include complexity, subjectivity, change, uncertainty, or susceptibility to misstatement due to management bias or other risk factors. Quantitative factors may include the financial significance of an account, transaction, or disclosure and the volume of transactions.

Key audit matter (KAM) (173) As included in the AICPA and international auditing standards, matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated to those charged with governance.

Lead schedule (195) A working paper with columnar headings similar to those in a working trial balance, set up to combine similar ledger accounts, the total of which appears in the working trial balance as a single amount.

Material (195) Of substantial importance. Significant enough to affect evaluations or decisions by users of financial statements. Information that should be disclosed so that financial statements constitute a fair presentation. Involves both qualitative and quantitative considerations.

Minutes (192) A formal record of the issues discussed and actions taken in meetings of stockholders or the board of directors.

Nonroutine transaction (163) A transaction that occurs only periodically, such as counting and pricing inventory, calculating depreciation expense, or determining prepaid expenses.

Permanent file (197) A file of working papers containing relatively unchanging data, such as copies of articles of incorporation and bylaws; copies of minutes of directors', stockholders', and committee meetings; and analyses of such ledger accounts as land and retained earnings.

Professional skepticism (167) An attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatements due to fraud or error, and a critical assessment of audit evidence.

Reasonable possibility (162) In the context of the risks of material misstatement, when the likelihood of a material misstatement occurring is more than remote.

Reclassification journal entry (RJE) (195) A working paper entry drafted by the auditors to assure fair presentation of the client's financial statements, such as an entry to transfer accounts receivable credit balances to the current liabilities section of the client's balance sheet. Because reclassification entries do not correct misstatements in the client company's accounting records, they are not posted to the client's ledger accounts.

Related party transaction (190) A transaction in which one party has the ability to influence significantly the management or operating policies of the other party, to the extent that one of the transacting parties might be prevented from pursuing fully its own separate interests.

Relevant assertion (162) An assertion about a class of transactions, account balance, or disclosure that has a reasonable possibility (its "likelihood") of being materially misstated (its "magnitude"). The determination of whether an assertion is a relevant assertion is made before considering any related controls (that is, the determination is based on inherent risk).

Report release date (193) The date the auditor grants the client permission to use the auditor's report. This date is ordinarily close to the audit report date.

Representation letter (172) A single letter or separate letters prepared by officers of the client company at the auditors' request setting forth certain representations about the company's financial position or operations.

Risk assessment procedures (168) Procedures performed by the auditor to obtain an understanding of the entity and its environment, including its internal control. Risk assessment procedures ordinarily include inquiries of management and others within the entity, analytical procedures, and observation and inspection. Risk assessment procedures often provide the auditors with a limited amount of evidence about the operating effectiveness of the client's internal control.

Risks of material misstatement (162) The risks that the financial statements are misstated. A risk of material misstatement exists when (a) there is a reasonable possibility of a misstatement occurring (that is, its likelihood) and (b) if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude). The risks of material misstatement are addressed by auditors at the *financial statement level* and at the *assertion level*. At the *financial statement level*, it relates to risks that relate pervasively to the financial statement as a whole and potentially may affect many assertions. At the *assertion level*, it relates to specific assertions and consists of two components: inherent risk and control risk.

Routine transaction (163) A transaction for a recurring financial activity recorded in the accounting records in the normal course of business, such as sales, purchases, cash receipts, cash disbursements, and payroll.

Scanning (175) The auditors' use of professional judgment to review accounting data to identify significant unusual items that will be tested.

Significant account balance, class of transactions, or disclosure (162) An account balance, class of transactions, or disclosure that includes one or more relevant assertions. The determination of significance is made before consideration of any related controls (that is, it is determined based on the assessment of inherent risk). Accordingly, an account balance, class of transactions, or disclosure is considered significant when it has *an identified risk of material misstatement* at the assertion level (that is, there are one or more relevant assertions).

Significant assumption (186) As related to an accounting estimate, an assumption for which a reasonable variation would materially affect the measurement of that accounting estimate.

Significant risk (162) An identified risk of material misstatement that, in the auditors' judgment, requires special audit consideration due to their assessment of its inherent risk. The auditors consider the likelihood of misstatement occurring and the magnitude of the potential misstatement both as high. Using the terminology of the AICPA, it is "close to the upper end of the spectrum of inherent risk." Also, professional standards define specific circumstances that constitute significant risks related to revenue recognition and certain related party transactions (AU-C 240 and 550 and PCAOB AS 2110).

Significant risk (186) Identified and assessed risks of material misstatement that, in the auditor's judgment, require special audit consideration.

Significant unusual transactions (190) Significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual due to their timing, size, or nature.

Specialist (172, 173) A person or firm possessing special skill or knowledge in a field other than auditing or accounting (e.g., an actuary). A person or firm with skill or knowledge in information technology or income taxes is not a specialist since those areas are considered specialized areas of accounting and auditing.

Spectrum of inherent risk (162) A term used in the AICPA and IAASB standards referring to the degree to which the level of inherent risk may vary when both its likelihood and its magnitude are considered.

Inherent risk may increase due to qualitative and quantitative inherent risk factors. Qualitative inherent risk factors relating to the preparation of financial statements may include complexity, subjectivity, change, uncertainty, or susceptibility to misstatement due to management bias or other risk factors. Quantitative factors may include the financial significance of an account, transaction, or disclosure and the volume of transactions.

Substantive procedures (tests) (168) Audit procedures designed to detect material misstatements. Substantive procedures include tests of details (account balances, transactions, and disclosures) and substantive analytical procedures.

Sufficient audit evidence (160, 166) A measure of the quantity of the audit evidence required. The quantity is affected by the auditor's assessment of the risks of material misstatement and the quality of the audit evidence obtained.

Tests of controls (168) Procedures performed by the auditor to test the operating effectiveness of controls in preventing or detecting material misstatements at the relevant assertion level.

Tick mark (198) A symbol used in working papers by the auditor to indicate a specific step in the work performed. Whenever tick marks are used, they should be accompanied by a legend explaining their meaning.

Top-side entries (163) Entries that generally do not appear in either journals or the general ledger. Often they are simply recorded directly on a spreadsheet that begins with the year-end recorded account totals. Examples of such entries that are generally appropriate include consolidation entries, segmental disaggregation (or aggregation) of certain accounts, and currency translations.

Vertical analysis (179) A form of analysis that presents financial statement amounts for a period as a percentage of some financial statement base. This analysis involves the preparation of *common-size financial statements*.

Working papers (191) Papers that document the evidence gathered by auditors to show the work they have done, the methods and procedures they have followed, and the conclusions they have developed in an audit of financial statements or other type of engagement.

Working trial balance (194) A working paper that lists the balances of accounts in the general ledger for the current and the previous year and also provides columns for the auditors' adjustments and reclassifications and for the final amounts that will appear in the financial statements.

Review Questions

- 5-1. Describe the relationship between detection risk and audit risk.
- 5-2. Identify and describe the two components of the risk of material misstatement.
- 5-3. Define *inherent risk*. Can the auditors reduce inherent risk by performing audit procedures?
- 5-4. Distinguish among routine, nonroutine, and estimation transactions. Include an example of each.
- 5-5. Distinguish between the components of audit risk that the auditors gather evidence to assess versus the component of audit risk that they collect evidence to restrict.
- 5-6. In a conversation with you, Mark Rogers, CPA, claims that both the *sufficiency* and the *appropriateness* of audit evidence are a matter of judgment in every audit. Do you agree? Explain.
- 5-7. Comment on the accuracy of the following statement: "Relevant assertions have in common that they have a reasonable possibility of being materially misstated after considering inherent risk and control risk."
- 5-8. Comment on the accuracy of the following statement: "A significant class of transactions, account balance or disclosure has one or more relevant assertions."
- 5-9. "The best means of verification of cash, inventory, office equipment, and nearly all other assets is a physical count of the units; only a physical count gives the auditors complete assurance as to the accuracy of the amounts listed on the balance sheet." Evaluate this statement.
- 5-10. As part of the verification of accounts receivable as of the balance sheet date, the auditors might inspect copies of sales invoices. Similarly, as part of the verification of accounts payable, the auditors might inspect purchase invoices. Which of these two types of invoices do you think represents the stronger type of evidence? Why?
- 5-11. Evaluate the following statement: A canceled check is not considered particularly reliable evidence because the check was prepared within the client's organization.
- 5-12. When in the course of an audit might the auditors find it useful to apply analytical procedures?
- 5-13. Provide an example in which a data analytics technique applied in financial statement auditing could serve as both a test of a control and a substantive procedure.
- 5-14. "Use of data analytics is likely to increase the use of sampling and eliminate the audit of all items in a population." Comment on the accuracy of this quotation.
- 5-15. Provide at least four examples of *specialists* whose findings might provide appropriate evidence for the independent auditors.
- 5-16. What are the major purposes of obtaining representation letters from audit clients?
- 5-17. The cost of an audit might be significantly reduced if the auditors relied upon a representation letter from the client instead of observing the physical counting of inventory. Would this use of a representation letter be an acceptable means of reducing the cost of an audit?
- 5-18. List and briefly describe the three approaches to auditing accounting estimates that are included in a client's financial statements.
- 5-19. In their audit of accounting estimates, auditors emphasize significant assumptions. Provide characteristics of such assumptions.
- 5-20. "In deciding upon the type of evidence to be gathered in support of a given item on the financial statements, the auditors should not be influenced by the differences in cost of obtaining alternative forms of evidence." Do you agree? Explain.
- 5-21. When auditing a client's asset that is valued at fair value, would the auditors expect that asset to be valued at the price to purchase the asset as of the measurement date or the price that would be received to sell it? Explain.
- 5-22. What are *related party transactions*?
- 5-23. What disclosures should be made in the financial statements regarding material related party transactions?
- 5-24. Evaluate the following statement: "Identifying related parties and obtaining a client representation letter are two required audit procedures normally performed on the last day of fieldwork."
- 5-25. What are the major functions of audit working papers?
- 5-26. Why are the prior year's audit working papers a useful reference to staff assistants during the current audit?
- 5-27. List the major types of audit working papers and give a brief explanation of each. For example: One type of audit working paper is an account analysis. This working paper shows the changes that occurred in a given account during the period under audit. By analyzing an account, the auditors determine its nature and content.

- 5-28. "Audit working papers are the property of the auditors, who may destroy the papers, sell them, or give them away." Criticize this quotation.
- 5-29. Describe a situation in which a set of audit working papers might be used by third parties to support a charge of gross negligence against the auditors.
- 5-30. Should the working trial balance prepared by the auditors include revenue and expense accounts if the balances of these accounts for the audit year have been closed into retained earnings prior to the auditors' arrival? Explain.
- 5-31. Why are the final figures from the prior year's audit included in a working trial balance or lead schedule?
- 5-32. Should the auditors prepare adjusting journal entries to correct all errors they discover in the accounting records for the year under audit? Explain.
- 5-33. Explain the meaning of the term *permanent file* as used in connection with audit working papers. What kinds of information are usually included in the permanent file?
- 5-34. List several rules to be observed in the preparation of working papers that reflect current professional practice.
- 5-35. "I have finished my testing of footings of the cash journals," said the associate auditor to the senior auditor. "Shall I state in the working papers the periods for which I verified footings, or should I just list the totals of the receipts and disbursements I have proved to be correct?" Prepare an answer to the assistant's question, stressing the reasoning involved.
- 5-36. What is the purpose of a "second partner review"? What should be the extent of the second partner's association with the engagement being reviewed?
- 5-37. In their review of audit working papers, what do managers and partners look for?

Questions Requiring Analysis

LO 5-1

LO 5-1

LO 5-4

LO 5-3, 4

LO 5-4

- 5-38. Financial statements contain a number of assertions about account balances, classes of transactions, and disclosures.
 - a. Identify who makes these assertions.
 - b. List and describe each of the assertions regarding each financial statement component.
- 5-39. Marion Watson & Co., CPAs, is planning its audit procedures for its tests of the valuation of inventories of East Coast Manufacturing Co. The auditors on the engagement have assessed inherent risk and control risk for valuation of inventories at 100 percent and 50 percent, respectively.
 - a. Calculate the appropriate level of detection risk for the audit of this assertion, given that the auditors wish to restrict audit risk for the assertion to 3 percent.
 - b. Calculate the appropriate level of detection risk for the audit of this assertion, given that the auditors wish to restrict audit risk for the assertion to 5 percent.
- 5-40. In an audit of financial statements, the auditors gather various types of audit evidence. List seven major types of evidence and provide a procedural example of each.
- 5-41. Comment on the reliability of each of the following examples of audit evidence. Arrange your answer in the form of a separate paragraph for each item. Explain fully the reasoning employed in judging the reliability of each item.
 - a. Copies of client's sales invoices.
 - b. Auditors' independent computation of earnings per share.
 - c. Paid checks returned with a bank statement.
 - d. Response from customer of client addressed to auditors' office confirming amount owed to client at balance sheet date.
 - e. Representation letter signed by controller of client company stating that all liabilities of which she has knowledge are reflected in the company's accounts.
- 5-42. Analytical procedures are extremely useful throughout the audit.
 - a. Explain how analytical procedures are useful in
 - (1) The risk assessment stage of the audit.
 - (2) The substantive procedures stage of the audit.
 - (3) Near the end of the audit.
 - b. List the five sources of information that are available to the auditors in developing expectations for analytical procedures.
 - c. List and describe four techniques that may be used by the auditors in developing expectations for analytical procedures.

- LO 5-4** 5-43. When analytical procedures disclose unexpected changes in financial relationships relative to prior years, the auditors consider the possible reasons for the changes. Give several possible reasons for the following significant changes in relationships:
- The rate of inventory turnover (ratio of cost of goods sold to average inventory) has declined from the prior year's rate.
 - The number of days' sales in accounts receivable (ratio of accounts receivable to average daily sales) has increased over the prior year.
- LO 5-4** 5-44. Auditors are required on every engagement to obtain a representation letter from the client.
- What are the objectives of the client's representation letter?
 - Who should prepare and sign the client's representation letter?
 - When should the client's representation letter be obtained?
- LO 5-4** 5-45. What would you accept as satisfactory documentary evidence in support of entries in the following?
- Sales journal.
 - Sales returns journal.
 - Voucher or invoice register.
 - Payroll journal.
 - Check register.
- LO 5-7** 5-46. "Working papers should contain facts and nothing but facts," said student A. "Not at all," replied student B. "The audit working papers also may include expressions of opinion. Facts are not always available to settle all issues." "In my opinion," said student C, "a mixture of facts and opinions in the audit working papers would be most confusing if the papers were produced as a means of supporting the auditors' position when their report has been challenged." Evaluate the issues underlying these arguments.
- LO 5-7** 5-47. At 12 o'clock, when the plant whistle sounded, George Jones, an assistant auditor, had been working on his laptop computer. Jones stopped work immediately, but not wanting to waste a lot of time, he simply closed his laptop. He then departed for lunch. The auditor-in-charge, who had been observing what was going on, was critical of the assistant's actions. What do you think was the basis for criticism by the auditor-in-charge?

Objective Questions

Select questions are available with Connect



- 5-48. **Multiple Choice Questions**
Select the best answer for each of the following questions. Explain the reasons for your selection.
- LO 5-1** a. Which of the following is *not* a financial statement assertion made by management?
- (1) Existence of recorded assets and liabilities.
 - (2) Completeness of recorded assets and liabilities.
 - (3) Valuation of assets and liabilities.
 - (4) Effectiveness of internal control.
- LO 5-2** b. Which of the following business characteristics is *not* indicative of high inherent risk?
- (1) Operating results that are highly sensitive to economic factors.
 - (2) Large likely misstatements detected in prior audits.
 - (3) Substantial turnover of management.
 - (4) A large amount of assets.
- LO 5-4** c. As part of their audit, auditors obtain a representation letter from their client. Which of the following is *not* a valid purpose of such a letter?
- (1) To increase the efficiency of the audit by eliminating the need for other audit procedures.
 - (2) To remind the client's management of its primary responsibility for the financial statements.
 - (3) To document in the audit working papers the client's responses to certain verbal inquiries made by the auditors during the engagement.
 - (4) To provide evidence in those areas dependent upon management's future intentions.

- LO 5-4** d. Which of the following statements best describes why auditors investigate related party transactions?
- (1) Related party transactions generally are illegal acts.
 - (2) The substance of related party transactions may differ from their form.
 - (3) All related party transactions must be eliminated as a step in preparing consolidated financial statements.
 - (4) Related party transactions are a form of management fraud.
- LO 5-3** e. Of the following, which is the *least* reliable type of audit evidence?
- (1) Confirmations mailed by outsiders to the auditors.
 - (2) Correspondence between the auditors and suppliers.
 - (3) Copies of sales invoices inspected by the auditors.
 - (4) Canceled checks returned in the year-end bank statement directly to the client.
- LO 5-4** f. Analytical procedures are most likely to detect:
- (1) Weaknesses of a material nature in internal control.
 - (2) Unusual transactions.
 - (3) Noncompliance with prescribed control activities.
 - (4) Improper separation of accounting and other financial duties.
- LO 5-4** g. Which of the following is *not* a primary approach to auditing an accounting estimate?
- (1) Review and test management's process for developing the estimate.
 - (2) Review subsequent transactions.
 - (3) Confirm the amounts.
 - (4) Develop an independent estimate.
- LO 5-7** h. A primary purpose of the audit working papers is to:
- (1) Aid the auditors by providing a list of required procedures.
 - (2) Provide a point of reference for future audit engagements.
 - (3) Support the underlying concepts included in the preparation of the basic financial statements.
 - (4) Support the auditors' opinion.
- LO 5-1** i. Relevant assertions are those that, without regard to the effect of controls, have at least what likelihood of containing a material misstatement?
- (1) Remote.
 - (2) Reasonable possibility.
 - (3) Probable.
 - (4) Certain.
- LO 5-6** j. Seeking and treating as more persuasive information that is consistent with one's initial beliefs describes which cognitive bias?
- (1) Overconfidence bias.
 - (2) Confirmation bias.
 - (3) Persuasiveness bias.
 - (4) Availability bias.
- LO 5-4** k. In using the work of a specialist, the auditors referred to the specialist's findings in their report. This would be an appropriate reporting practice if the:
- (1) Client is not familiar with the professional certification, personal reputation, or particular competence of the specialist.
 - (2) Auditors, as a result of the specialist's findings, give a qualified opinion on the financial statements.
 - (3) Client understands the auditors' corroborative use of the specialist's findings in relation to the representations in the financial statements.
 - (4) Auditors, as a result of the specialist's findings, decide to indicate a division of responsibility with the specialist.

LO 5-7

l. A difference of opinion concerning accounting and auditing matters relative to a particular phase of the audit arises between an assistant auditor and the auditor responsible for the engagement. After appropriate consultation, the assistant auditor asks to be disassociated from the resolution of the matter. The working papers would probably:

- (1) Remain silent on the matter since it is an internal matter of the auditing firm.
- (2) Note that the assistant auditor is completely dissociated from responsibility for the auditors' opinion.
- (3) Document the additional work required because all disagreements of this type will require expanded substantive procedures.
- (4) Document the assistant auditor's position and how the difference of opinion was resolved.

LO 5-1, 2, 4

5-49. **Simulation**

Auditors consider financial statement assertions to identify appropriate audit procedures. For items *a* through *f*, match each assertion with the statement that most closely approximates its meaning. Each statement may be used only once.

Assertion	Statement
<i>a.</i> Completeness	1. There is such an asset.
<i>b.</i> Cutoff	2. The company legally owns the assets.
<i>c.</i> Existence and occurrence	3. All assets have been recorded.
<i>d.</i> Presentation	4. Transactions are recorded in the correct accounting period.
<i>e.</i> Rights and obligations	5. Assets are recorded at proper amounts.
<i>f.</i> Valuation	6. Assets are properly classified.

Auditors perform audit procedures to obtain audit evidence that will allow them to draw reasonable conclusions as to whether the client's financial statements follow generally accepted accounting principles. Match each audit procedure with its type. Each type of audit procedure is used; one is used twice.

Audit Procedures	Type of Audit Procedure
<i>g.</i> Prepare a flowchart of internal control over sales.	7. Analytical procedures
<i>h.</i> Calculate the ratio of bad debt expense to credit sales.	8. Tests of controls
<i>i.</i> Determine whether disbursements are properly approved.	9. Risk assessment procedures (other than analytical procedures)
<i>j.</i> Confirm accounts receivable.	10. Test of details of account balances, transactions, or disclosures
<i>k.</i> Compare current financial information with comparable prior periods.	

LO 5-1, 2, 3

5-50. State whether each of the following statements is correct or incorrect concerning audit risk and its components—inherent risk, control risk, and detection risk.

- a.* The risk of material misstatement is composed of the three components of audit risk.
- b.* Inherent risk is the possibility of material misstatement before considering the client's internal control.
- c.* Less control risk means an increase in the risk of material misstatement.
- d.* Detection risk does not exist when no audit is performed.
- e.* Rather than restrict detection risk through the performance of more substantive procedures, auditors assess it.
- f.* Absent any other changes, an increase in the risk of material misstatement results in an increase in audit risk.
- g.* Audit risk refers to the possibility that the auditors may express an inappropriate opinion on financial statements that are materially or immaterially misstated.
- h.* Both inherent risk and control risk exist independently of the audit of financial statements.

- LO 5-4** 5–51. Reply to the following questions relating to analytical procedures.
- Performing analytical procedures may help an auditor to:
 - Achieve audit objectives related to a particular assertion.
 - Develop an effective system of quality control.
 - Meet PCAOB requirements that analytical procedures be performed relating to every major account.
 - Increase the level of detection risk.
 - Analytical procedures performed near the end of the audit to assist the auditor in forming an overall conclusion on the financial statements are aimed primarily at:
 - Gathering evidence concerning account balances that have not changed from the prior year.
 - Retesting internal control procedures.
 - Considering unusual or unexpected account balances that were not previously identified.
 - Performing a test of transactions to corroborate management's financial statement assertions.
 - What type of analytical procedure would an auditor most likely use in developing relationships among balance sheet accounts?
 - Trend analysis.
 - A detailed test of balance analysis.
 - Ratio analysis.
 - Risk analysis.
 - The cost of analytical procedures in terms of time needed to perform, when compared to other tests, is ordinarily considered:
 - Low.
 - High.
 - Identical.
 - Indeterminate.
 - In developing an expectation for analytical procedures, the auditors are least likely to consider:
 - Financial information for comparable prior periods.
 - Relationships between financial information and relevant nonfinancial data.
 - Anticipated costs of audit completion.
 - Relationships among elements of financial information within a period.

- LO 5-2, 3, 6** 5–52. For each term in the first column, select the partial (or complete) definition or illustration. Each partial (or complete) definition or illustration may be used only once, or not at all.

Term	Partial (or Complete) Definition or Illustration
a. Anchoring bias	1. Overvaluing information that quickly comes to mind.
b. Availability bias	2. Starting with an initial belief and then insufficiently adjusting that belief when contrary information is encountered.
c. Confirmation bias	3. Seeking and treating as more persuasive information that is consistent with one's beliefs.
d. Audit evidence	4. Overestimating one's abilities.
e. Control risk	5. All information prepared within the audited organization.
f. Professional skepticism	6. Information used by the auditor that corroborates or contradicts the assertions in the financial statements.
g. Relevant assertion	7. Information used by the auditor that corroborates the assertions in the financial statements.
h. Significant assumption	8. The risk that the auditors' procedures will lead them to conclude that a misstatement does not exist when in fact it does exist.

Term	Partial (or Complete) Definition or Illustration
	9. The risk that a material misstatement that could occur will not be prevented or detected on a timely basis.
	10. A financial statement assertion that is probable of misstatement given the nature of the further audit procedures performed.
	11. A financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated.
	12. A financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially or immaterially misstated.
	13. An attitude that includes a questioning mind, and a critical assessment of audit evidence.
	14. An attitude that includes a subjective mind and a detailed assessment of audit evidence.
	15. Every assumption relating to a significant financial statement assertion.
	16. As related to an accounting estimate, an assumption for which a reasonable variation would materially affect the measurement of that accounting estimate.

- LO 5-5** 5–53. During the audit of a dealership selling only new luxury automobiles, the auditors calculated the year 2 and year 1 ratios in the table below.

Ratios	Year 2	Year 1	Explanations
Days sales in accounts receivable	32	20	Question 1
Inventory turnover	4.01	6.32	Question 2
Debt to equity	3.2	4.3	Question 3
Return on assets	10.5%	12.2%	Question 4
Net fixed assets to equity	19.1%	23.2%	Question 5

Select the most reasonable explanation the controller will provide relating to year 2 for each change. An explanation may be used once, more than once, or not at all. Consider each ratio independently.

Explanation: Event Occurring in Year 2

- Due to a more severe than expected economic downturn, buyers have shifted to economy cars, resulting in higher than expected ending year 2 inventory.
- Early in the year, the company hired additional collection clerks.
- At year-end, the company removed some fully depreciated machinery from its books.
- The board of directors implemented and began a buyback of company stock.
- The company promoted its assistant treasurer to replace its recently retired treasurer.
- The company increased the annual dividend to shareholders.
- The company instituted more stringent collection policies.
- The company made a required principal payment on its long-term debt.
- The company reclassified its international production facilities to held-for-sale.
- Positive consumer reviews have caused increased sales of cars and a lower year 2 ending inventory as the manufacturing process has been strained by capacity constraints.
- Sales managers recorded fraudulent sales at year-end to receive larger commissions.

(AICPA, adapted)

Problems LO 5-1

- 5-54. Audit risk should be considered when planning and performing an audit of financial statements in accordance with generally accepted auditing standards.
- Define audit risk.
 - Describe its components of inherent risk, control risk, and detection risk.
 - Explain the interrelationship among these components.
 - Which (if any) of these components is completely a function of the sufficiency of the evidence gathered by the auditors' procedures? Explain your answer.
 - Comment on the following: "Since cash is often less than 1 percent of total assets, inherent and control risk for that account must be low. Accordingly, detection risk should be established at a high level."

(AICPA, adapted)

LO 5-3, 4

- 5-55. Assume that the auditors find serious weaknesses in the internal control of Oak Canyon Inc., a producer and distributor of fine wines. Would these internal control weaknesses cause the auditors to rely more or less upon each of the following types of evidence during their audit of Oak Canyon?
- Documents created and used only within the organization.
 - Physical evidence.
 - Evidence provided by specialists.
 - Analytical procedures.
 - Accounting records.

For each of the above five items, state your conclusion and explain fully the underlying reasoning.

LO 5-3, 4

- 5-56. During your examination of the accounts receivable of Hope Ranch, a new client, you notice that one account is much larger than the rest, and you therefore decide to examine the evidence supporting this customer's account. Comment on the relative reliability and adequacy of the following types of evidence:
- Computer printout from accounts receivable subsidiary ledger.
 - Copies of sales invoices in amount of the receivable.
 - Purchase orders received from customer.
 - Shipping documents describing the articles sold.
 - Letter received by client from customer acknowledging the correctness of the receivable in the amount shown on client's accounting records.
 - Letter received by auditors directly from customer acknowledging the correctness of the amount shown as receivable on client's accounting records.

LO 5-4

- 5-57. Trend analysis, common-size financial statements, and ratios are presented for the Brody Corporation in Figure 5.4. Assume that you are auditing Brody's financial statements for the year ended December 31, 20X8. You have performed tests of controls over the recording of gross sales and believe that the system is operating effectively and that 7 percent represents an accurate estimate of the increase in gross sales for 20X8 over the amount for 20X7. You also should assume that the financial statements for 20X6 and 20X7 are not misstated.
- Analyze Figure 5.4 and identify any accounts that appear to represent significant variations from what one might expect. For each of the accounts, identify another account that might also be out of line due to the manner in which the double-entry bookkeeping system records transactions.
 - Identify any ratios that appear to represent significant variations from what one might expect. For each ratio, identify the financial statement account or accounts that may be misstated.

LO 5-6

- 5-58. Included in the financial statements are a variety of accounting estimates (e.g., allowance for doubtful accounts, obsolete inventory, warranty liability). Audit procedures should be designed to obtain evidence about the assertions of management related to all accounts, including those based on accounting estimates.
- List three approaches to auditing accounting estimates. Provide an example of how an auditor might apply each of the three approaches in auditing the allowance for doubtful accounts, which management has established at 1 percent of credit sales.
 - Discuss the meaning of the valuation or allocation assertion as it relates to the allowance for doubtful accounts.
 - Discuss factors that bear on whether the allowance for doubtful accounts is likely to be an account with high inherent risk.

- LO 5-4, 7** 5-59. Criticize the following working paper that you are reviewing as senior auditor on the December 31 audit of Pratt Company.

Pratt Company Cash		
Per bank		\$44,874.50✓
Deposit in transit		5,843.10①
Bank charges		(2.80)②
Outstanding checks		
	1,246.40✓	
	3,412.72✓	
	840.00✓	
	1,013.60③	
	1,200.00③	
	967.50Y	8,680.22
Per ledger	f	\$42,034.58✓
f Footed column		
✓ Verified		
①The client saved a copy of the deposit slip that is filled out. Per discussion with client, this represents cash sales on 12/31/X0. I agreed totals to the Cash Receipts Journal on 12/31/X0. Properly posted on bank statement as having been received by bank on 1/9/X1.		
②Represents December bank service charge. Agreed charge to December bank statement in which bank charged client \$2.80. Recorded as cash disbursement in January of 20X1.		
③Per client, check written (to pay account receivable) before year-end but not mailed until 1/2/X1 because on 12/31/X0 the last office mail was picked up at 3 pm due to year-end party of mailroom employees.		
J.M.W.		
1-15-X1		

- LO 5-4** 5-60. Marilyn Terrill is the senior auditor for the audit of Uden Supply Company for the year ended December 31, 20X4. In planning the audit, Marilyn is attempting to develop expectations for planning analytical procedures based on the financial information for prior years and her knowledge of the business and the industry, including these:
1. Based on economic conditions, she believes that the increase in sales for the current year should approximate the historical trend in terms of actual dollar increases.
 2. Based on her knowledge of industry trends, she believes that the gross profit percentage for 20X4 should be about 2 percent less than the percentage for 20X3.
 3. Based on her knowledge of regulations, she is aware that the effective tax rate for the company for 20X4 has been reduced by 5 percent from that in 20X3.
 4. Based on a review of the general ledger, she determined that average depreciable assets have increased by 10 percent. Purchases of equipment occurred relatively evenly throughout the year.
 5. Based on her knowledge of economic conditions, she is aware that the effective interest rate on the company's line of credit for 20X4 was approximately 12 percent. The average outstanding balance of the line of credit is \$2,300,000. This line of credit is the company's only interest-bearing debt.
 6. Based on her discussions with management and her knowledge of the industry, she believes that the amount of other expenses should be consistent with the trends from prior years. Comparative income statement information for Uden Supply Company is presented in the accompanying table.
 - a. Describe the purpose of analytical procedures performed in the risk assessment stage of the audit.
 - b. Develop the expected amounts for 20X4 for each of the income statement items.

- c. Uden's unaudited financial statements for the current year show a 31 percent gross profit rate. Assuming that this represents a misstatement from the amount that you developed as an expectation, calculate the estimated effect of this misstatement on net income before taxes for 20X4.
- d. Indicate whether you believe that the difference calculated in requirement (c) is material. Explain your answer.

UDEN SUPPLY COMPANY				
Comparative Income Statements				
Years Ended December 20X1, 20X2, and 20X3				
(Thousands)				
	20X1 Audited	20X2 Audited	20X3 Audited	20X4 Expected
Sales	8,700	9,400	10,100	
Cost of goods sold	6,000	6,500	7,000	
Gross profit	2,700	2,900	3,100	
Sales commissions	610	660	710	
Advertising	175	190	202	
Salaries	1,061	1,082	1,103	
Payroll taxes	184	192	199	
Employee benefits	167	174	181	
Rent	60	61	62	
Depreciation	60	63	66	
Supplies	26	28	30	
Utilities	21	22	23	
Legal and accounting	34	37	40	
Miscellaneous	12	13	14	
Interest expense	210	228	240	
Net income before taxes	80	150	230	
Income taxes	18	33	50	
Net income	62	117	180	

In-Class Team Case

LO 5-4



- 5-61. Houseco, an audit client of Jones, CPA, for the past five years, is a manufacturer of various household products. Approximately four years ago, Houseco developed a better toaster than had been available and sales took off, especially during the most recent two years, 20X7 and 20X8. Currently, the company controls approximately 25 percent of the toaster market in the United States. In addition, the company manufactures other products, including vacuum cleaners, floor polishers, and electric fondue pots. Much of the increased sales performance is due to Donald Skaldon, who became the chief executive officer in 20X4. Donald and several other officers were able to accomplish a leveraged stock buyout in 20X6. This seems to have worked out very well because Donald suggests that his net worth grew from less than \$300,000 to well over \$5 million due to increases in the value of the common stock he holds in the company. He is also excited because the company's unaudited results show earnings per share of \$1.21, one cent more than the most optimistic analysts had projected. He points out to Jones that sales are up over 38 percent compared to the previous year and net income has increased by 54 percent. All is well. Jones is beginning the risk assessment analytical procedures for the 20X8 audit to obtain information to help plan the nature, timing, and extent of other audit procedures. More specifically, he wants to identify areas that may represent specific risks relevant to this year's audit.

Use the Houseco balance sheet and income statement to identify accounts that may represent specific risks relevant to this year's audit. For each area, briefly note why you think it represents a risk (see pages 205 and 206).

Houseco Balance Sheet

	Dollars (000s Omitted)			Vertical Analysis			Horizontal Analysis	
	12/31/X6 (Audited)	12/31/X7 (Audited)	12/31/X8 (Unaudited)	12/31/X6 (Audited)	12/31/X7 (Audited)	12/31/X8 (Unaudited)	(X7-X6)/X6 (Audited)	(X8-X7)/X7 (Unaudited)
Assets								
Cash	63	514	885	0%	1%	1%	716%	72%
Accounts receivable	14,402	27,801	51,076	33%	43%	43%	93%	84%
Inventories—RM	2,682	9,182	18,049	6%	14%	15%	242%	97%
Inventories—WIP	491	638	4,151	1%	1%	4%	30%	551%
Inventories—FG	6,589	9,757	16,935	15%	15%	14%	48%	74%
Total inventories	9,762	19,577	39,153	23%	30%	33%	101%	100%
Other current assets	708	1,449	3,015	2%	2%	3%	105%	108%
Total current assets	24,935	49,341	94,111	58%	76%	80%	98%	91%
Fixed assets (net)	18,267	15,900	24,029	42%	24%	20%	(13%)	51%
Total assets	43,202	65,241	118,140	100%	100%	100%	51%	81%
Liability and Equity								
Accounts payable	7,344	15,072	13,288	17%	23%	11%	105%	(12%)
Accrued liabilities	3,127	5,468	4,710	7%	8%	4%	75%	(14%)
Current portion L/T debt	2,707	900	1,250	6%	1%	1%	(67%)	39%
Income taxes payable	1,554	2,619	3,782	4%	4%	3%	69%	44%
Total current liabilities	14,732	24,059	23,030	34%	37%	19%	63%	(4%)
Bank debt	14,800	19,841	62,057	34%	30%	53%	34%	213%
Deferred income taxes	685	1,254	1,881	2%	2%	2%	83%	50%
Total liabilities	30,217	45,154	86,968	70%	69%	74%	49%	93%
Common stock	7,775	7,775	7,903	18%	12%	7%	0%	2%
Retained earnings	5,210	12,312	23,269	12%	19%	20%	136%	89%
Total liabilities and equity	43,202	65,241	118,140	100%	100%	100%	51%	81%

Houseco Income Statement									
	Dollars (000s Omitted)				Vertical Analysis			Horizontal Analysis	
	12/31/X6 (Audited)	12/31/X7 (Audited)	12/31/X8 (Unaudited)		12/31/X6 (Audited)	12/31/X7 (Audited)	12/31/X8 (Unaudited)	(X7-X6)/X6 (Audited)	(X8-X7)/X7 (Unaudited)
Gross sales	78,428	133,504	183,767		103%	104%	101%	70%	38%
Less: Returns and allowances	2,284	5,270	2,644		3%	4%	1%	131%	(50%)
Net sales	76,144	128,234	181,123		100%	100%	100%	68%	41%
Cost of goods sold	46,213	70,756	94,934		61%	55%	52%	53%	34%
Gross margin	29,931	57,478	86,189		39%	45%	48%	92%	50%
Sell, advertising, R&D expenses	20,105	42,600	64,285		26%	33%	35%	112%	51%
Income from operations	9,826	14,878	21,904		13%	12%	12%	51%	47%
Interest expense	1,930	1,584	3,189		3%	1%	2%	(18%)	101%
Income before taxes	7,896	13,294	18,715		10%	10%	10%	68%	41%
Income taxes	3,807	6,189	7,761		5%	5%	4%	63%	25%
Net income	4,089	7,105	10,954		5%	6%	6%	74%	54%
EPS	0.46	0.78	1.21						
Ratios									
Current	1.7	2.1	4.1						
Quick	1.0	1.2	2.3						
Receivable turnover	5.3	6.3	4.7						
Days' sales in ending receivables	68.1	57.1	76.6						
Inventory turnover	4.7	4.8	3.2						
Days' sales in ending inventory	76.0	75.0	112.5						
Interest expense/Debt	0.11	0.08	0.05						

Research and Discussion Case

LO 5-1, 3, 4



- 5–62. You are the partner on the audit of Datasave Inc., a small publicly held corporation that manufactures high-speed disk drives for the computer industry. The audit of Datasave had been progressing satisfactorily until you were about a month away from issuing your opinion. Suddenly, and quite mysteriously, Carl Wagner, the financial vice president, resigned. John Ross, who had been a manager with a large CPA firm, was quickly hired to replace Wagner. Although the change in Datasave's chief financial officer caused some disruption, the audit was completed on a timely basis.

As the last step in the audit process, you have prepared the representation letter for signing. You wanted the letter to be signed by William Cox, the president; Robert Star, the controller; and Wagner, who occasionally came to the company's offices to resolve matters regarding his past compensation. The signatures of Cox and Star were obtained, and you approached Wagner for his signature. In response to your request, Wagner replied, "I no longer am employed with this crazy company. Why should I take any responsibility for the financial statements?" Despite your attempts to persuade him, Wagner refused to sign the letter. Wagner also refused to discuss the reasons for his resignation, other than to say the reasons were personal.

When you discussed the problem of Wagner's refusal to sign with Cox, he indicated that there was no problem because Ross would sign the letter. You see this as a possible solution, but you are aware that Ross knows very little about the financial statements for the year under audit. Also, you are still somewhat concerned about the reasons for Wagner's resignation.

- Describe fully the alternatives that are available to you in this situation.
- Express your personal opinion as to the appropriate course of action and provide reasoning to support your opinion.
- Could the CPA firm have validly refused to surrender the subpoenaed working papers to the IRS? Explain.

Supplementary References

Part (a):

This text, Chapter 4.

Part (b):

An intermediate accounting text.

PCAOB AS 2805. PCAOB AS 2801.

FASB Accounting Standards Codification section 450-20, "Loss Contingencies."

Part (c):

This text, Chapter 3.

Appendix 5A



Selected Internet Addresses

Accounting and Auditing Websites

American Institute of CPAs—www.aicpa.org

Association of Certified Fraud Examiners—www.acfe.com

The Committee of Sponsoring Organizations of the Treadway Commission (COSO)—www.coso.org

The Institute of Internal Auditors—www.theiia.org

The International Federation of Accountants—www.ifac.org

Large Accounting Firms

BDO USA—www.bdo.com/
Deloitte—www.deloitte.com/
EY—www.ey.com/
Grant Thornton—www.grantthornton.com
KPMG—www.home.kpmg.com/us/en/home.xhtml
<https://>
PwC—www.pwc.com
[ps:///](https://)
RSM—www.rsmus.com/

Securities and Exchange Commission

Home page—www.sec.gov/
EDGAR page—www.sec.gov/edgar.shtml
Securities Act of 1933—www.sec.gov/about/laws/sa33.pdf
Securities Exchange Act of 1934—www.sec.gov/about/laws/sea34.pdf

Public Company Accounting Oversight Board

PCAOB—www.pcaob.org
SOX since act of '33 and 34—<https://www.congress.gov/107/plaws/publ204/PLAW-107publ204.pdf>

Audit Planning, Understanding the Client, Assessing Risks, and Responding

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 6-1** Describe the major steps in the audit process.
- LO 6-2** Identify the factors that auditors consider in accepting new clients.
- LO 6-3** Explain the auditors' responsibilities when planning an audit.
- LO 6-4** Describe the nature of the risk assessment procedures that auditors use to obtain an understanding of the client and its environment.
- LO 6-5** Describe the process by which auditors assess the risks of material misstatement in the financial statements.
- LO 6-6** Describe how the auditors address fraud risk.
- LO 6-7** Discuss how the auditors design further audit procedures in response to the assessed risks of material misstatement.
- LO 6-8** Distinguish between the systems and the substantive procedures portions of the audit plan.

In this chapter, we first provide an overview of the entire audit process. Then we discuss obtaining a client, planning an audit, obtaining an understanding of the client and its industry, assessing risks related to the client, and responding to those risks. We address questions such as: How do auditors determine whether a prospective client should be accepted as a client? After accepting an audit client, how do auditors go about planning the engagement and identifying the areas with a “high risk” of material misstatement? When one considers the potential legal liability involved, it becomes obvious that auditors do not merely accept a new audit client and then arrive at the premises to “start auditing.”

The Audit Process

LO 6-1

Describe the major steps in the audit process.

Although specific audit procedures vary from one engagement to the next, the following stages are involved with every engagement:

1. Plan the audit.
2. Obtain an understanding of the client and its environment, including internal control.
3. Assess the risks of misstatement and design further audit procedures.
4. Perform further audit procedures.
5. Complete the audit.
6. Form an opinion and issue the audit report.

1. Plan the Audit

Audit planning begins with determining the requirements for the engagement, including the financial statements to be audited, any other requirements (e.g., regulatory filings), and the timing of the engagement. During this stage, auditors establish an understanding with their client as to the nature of services to be provided and the responsibilities of each party. In addition, they develop an overall audit strategy and an audit plan. Planning includes determining the analytical and other procedures to be applied as risk assessment procedures, the level of materiality, and the likely need for specialists.

While we describe the audit planning process as the first step in an audit, it should be recognized that significant portions of the planning process cannot be completed until the auditors have a sufficient understanding of the client and its environment, including internal control. Therefore, in the first audit of a new client, much of the planning process will be performed after the auditors have obtained this understanding, as described in stage two. In the audit of a continuing client, the auditors will have gained most of the required understanding and, therefore, may do most of the planning at the beginning of the audit.

It should be recognized that in audit planning, auditors use a risk-based approach in which they are continually considering the possibility of material financial statement misstatements. Accordingly, the plan may need to be revised as a result of information on risks as well as audit findings that are gathered throughout the audit. As an example, if the auditors' procedures reveal material misstatements in one account, this finding may lead them to plan additional audit procedures for other accounts that might be affected by factors similar to those affecting the misstated account.

2. Obtain an Understanding of the Client and Its Environment

Auditors should gather sufficient background information to assess the risks of material misstatement of the financial statements and to design the nature, timing, and extent of further audit procedures. **Risk assessment procedures** are used to gather this information and include researching the characteristics of the client and its industry, inquiries of management, analytical procedures, observation and inspection, and other procedures. At this stage of the audit, the auditors are attempting to obtain an overall understanding of the client and its environment, including its industry; objectives and strategies and related business risks; the manner in which management measures and reviews financial performance; and the client's internal control. This understanding helps the auditors to identify the risks of material misstatement of account balances, transactions, and disclosures.

Obtaining an understanding of the nature of internal control is an essential part of this process because it allows auditors to identify accounts and classes of transactions that may be misstated and to tailor audit procedures to the existing internal control system. Information on internal control comes from interviewing client personnel, observing the application of specific controls, inspecting documents and reports, and tracing transactions through the information system, as well as reviewing prior years' audit working papers.

3. Assess the Risks of Misstatement and Design Further Audit Procedures

Auditors use their understanding of the client and its environment to identify account balances, transactions, and disclosures that might be materially misstated. Data analytic techniques (discussed in Chapter 5 and Appendix 6A to this chapter) can be used as a part of the risk assessment process, as well as for tests of controls, substantive procedures, or procedures to form an overall conclusion on the financial statements.

During the risk assessment process, at the assertion level, the auditors consider

- What could go wrong?
- How likely is it that it will go wrong?
- What are the likely amounts involved?

Information gathering procedures provide the auditors with evidence on inherent and control risks for significant assertions. Remember that **inherent risk** is the risk of material misstatement of a financial statement **assertion** before considering any related controls. Many inherent risks arise because of **business risks** faced by management, including the possibility of material misstatement due to fraud.

The auditors' consideration of **control risk** involves analyzing the design and implementation of internal control to decide whether the internal control system appears adequate to prevent or detect and correct material misstatements. For example, if the auditors believe that inherent risk is higher for an important area and internal control is weak (i.e., control risk is high), they will assess the risk of material misstatement as high. On the other hand, if inherent risk is assessed as low and controls seem capable of preventing or detecting and correcting misstatements, the auditors may decide to perform tests of controls to support an assessment that control risk is low. If those tests provide evidence that the controls are operating effectively, the auditors may conclude that the risk of material misstatement is also low.

Based on the assessed risk of misstatement for various account balances, classes of transactions, and disclosures, the auditors will design and perform further audit procedures.

4. Perform Further Audit Procedures

Further audit procedures include a combination of additional **tests of controls** and **substantive procedures** relating to account balances, transactions, and disclosures. Tests of controls are performed to determine whether key controls are properly designed and *operating effectively*. To illustrate a test of a control, consider the control activity in which the accounting department accounts for the serial sequence of all shipping documents before preparing the related journal entries. The purpose of this control is to ensure that all shipments of merchandise are billed and recorded in the accounting

records (i.e., to ensure the completeness of recorded sales and accounts receivable). To test the operating effectiveness of the control, the auditors might inspect evidence of the client's accounting for the sequence of shipping documents and select a sample of shipping documents prepared at various times throughout the year to inspect the evidence that the related sales invoice was properly prepared and recorded.

Notice that a test of a control measures the effectiveness of a particular control in preventing or detecting a misstatement; it *does not* substantiate the dollar amount of an account balance. Also, a particular control may affect several financial statement accounts. If, for example, the tests described in the preceding paragraph indicate that the accounting department does not effectively account for the serial sequence of shipping documents, the auditors should be alert for the possibility of misstatements of sales revenue, accounts receivable, cost of goods sold, and inventories. Internal control is discussed further in Chapter 7.

Substantive procedures are performed to restrict detection risk, the risk that auditors will not detect a material misstatement. These procedures, described in detail in Chapter 5, include direct tests of account balances, transactions, and disclosures, as well as substantive analytical procedures. Chapters 10 through 16 provide detailed examples and discussions of these further audit tests for the various financial statement accounts.

5. Complete the Audit

The auditors perform a number of procedures near the time of completion of the audit. These procedures, discussed in detail in Chapter 16, include completing the search for unrecorded liabilities, completing the review of minutes of meetings, performing final analytical procedures, completing the search to identify loss contingencies and subsequent events, and obtaining a representation letter from management. Finally, overall audit findings are evaluated to arrive at a conclusion as to whether the financial statements follow generally accepted accounting principles.

6. Form an Opinion and Issue the Audit Report

The final step in the process is issuance of the audit report based on the conclusions reached in the preceding steps. Details on audit reports are presented in Chapter 17.

These six stages in the audit process are summarized in Figure 6.1. In addition to presenting information on obtaining clients, the remainder of this chapter emphasizes the first four steps of the audit process: (1) plan the audit, (2) obtain an understanding of the client and its environment, (3) assess the risk of misstatement, and (4) perform further audit procedures. Because of the complexity of internal control issues, Chapters 7 and 8 provide detailed information on that topic. Chapters 16 and 17 discuss completing the audit and the types of audit reports issued. The remaining chapters discuss audit sampling (Chapter 9); details on audit evidence relating to various account balances, classes of transactions, and disclosures (Chapters 10 through 16); and various other reporting issues (Chapters 18 through 21).

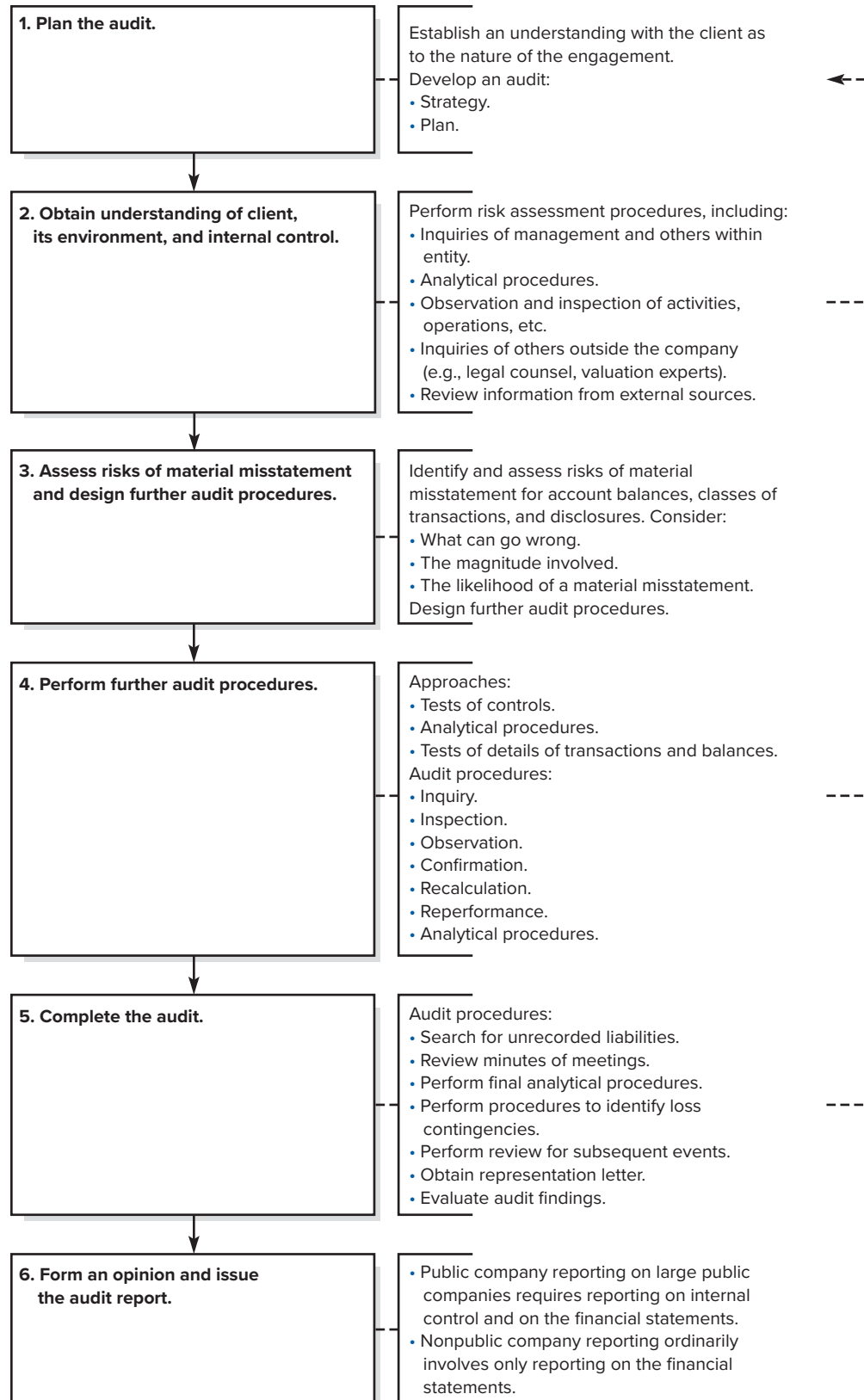
Obtaining Clients

LO 6-2

Identify the factors that auditors consider in accepting new clients.

Public accounting is a competitive profession, and most CPA firms are anxious to obtain new clients. Some new engagements are easily obtained through business transactions, such as the acquisition of a company by an existing client and the client's desire to have the entire audit performed by one CPA firm. Others are obtained competitively based on the firm's reputation or a partner's business or social contacts, which lead to a request that the CPA firm submit a proposal for performing the company's annual audit. Such prospective clients may range from start-up companies seeking a first audit to long-established companies considering replacing their current auditor. What risks are involved with a prospective new client? How does a CPA firm evaluate the risk associated with a prospective new client? What other professional responsibilities exist relating to acquiring a new client?

FIGURE 6.1
Stages of an Audit



As a starting point, it is essential for a CPA firm to maintain its integrity, objectivity, and reputation for providing high-quality services. CPA firms cannot afford to be regularly associated with clients that engage in management fraud or other inappropriate behavior. The continuing wave of litigation involving auditors underscores the need for CPA firms to develop quality control policies for thoroughly investigating prospective clients *before accepting an engagement*. The CPAs should investigate the history of the prospective client, including such matters as the identities and reputations of the directors, officers, and major stockholders. Much of this type of information may be discovered through inquiries and a search of online databases.

Even if the auditors perform an audit in accordance with auditing standards, they may be sued by stockholders or creditors that sustain a loss. Therefore, auditors will consider the reputation of management and the financial strength and credit rating of a prospective client to help assess the overall risk of association with the particular business. This overall risk is often referred to as **engagement risk**.

To help assess engagement risk, the auditors generally obtain management's permission to make inquiries of other third parties about a prospective audit client. For example, the client's banker can provide information regarding the client's financial history and credit rating. The client's legal counsel can provide information about the client's legal environment, including such matters as pending litigation and disputes with regulatory agencies. Such information also will assist the auditors in assessing the integrity of management.

Engagement risk is increased when the client company is in a weak financial position or is greatly in need of additional capital. When an audit client goes bankrupt, the auditors often are named as defendants in lengthy and costly lawsuits, with possible damage to their professional reputation. For that reason, some CPAs choose to avoid engagements entailing a relatively high engagement risk; others may accept such engagements, recognizing the need to expand audit procedures (and increase audit fees) to compensate for the unusually high levels of risk.

In addition to evaluating engagement risk, the auditors should consider whether they can complete the audit in accordance with the required auditing standards, AICPA generally accepted auditing standards for nonpublic companies and PCAOB standards for public companies. As discussed in Chapter 3, the CPA firm must be independent of the client to perform an audit. Therefore, the auditors must determine whether there are any conditions that would prevent them from performing an *independent* audit of the client. Consideration also will be given to whether the partners and staff have appropriate training and experience to competently complete the engagement. If the auditors have no experience in a particularly complex industry, they may decide that a competent audit of a prospective client in that industry cannot be performed unless the CPA firm hires appropriately experienced personnel.

Submitting a Proposal

To obtain the audit, the auditors may be asked to submit a competitive proposal that will include information on the nature of services that the firm offers, the qualifications of the firm's personnel, anticipated fees, and other information to convince the prospective client to select the firm. The CPA firm also may be asked to make an oral presentation to the prospective client's audit committee and management to provide a basis for the selection. As discussed in further detail later in this chapter, when the auditors replace other auditors, they should attempt to communicate with the predecessor auditors before making a final decision to accept the new engagement.

Audit Committees

Arrangements for the audit should be made through contact with the company's **audit committee**. Public companies must establish such a committee within the board of directors to take an active role in overseeing the company's accounting and financial reporting policies and practices. Audit committees are required by the New York Stock Exchange, the American Stock Exchange, and Nasdaq.



Illustrative Case

Fraud at ZZZZ Best Co.



ZZZZ Best Co. was a carpet cleaning company started by Barry Minkow, a 16-year-old high school student. Although the company experienced significant growth during its early years, it was not fast enough for Minkow. He hired several officers with criminal records and conceived a plan to restore damaged buildings for insurance companies. A number of multimillion-dollar restoration contracts were supposedly undertaken that later were found to be completely fictitious. Minkow attempted to cover up the

scheme by spending several million dollars to lease a building and make it appear to be a legitimate restoration project when the CPAs insisted upon visiting the site. Prior to the time the fraud was uncovered, the company's stock had a market value in excess of \$211 million. Shortly thereafter, the stock was worthless. This case clearly illustrates the risks involved in accepting young companies with rapid growth, the need to investigate the background of key officers of a company, and the need to have a thorough understanding of the client's operations and industry.

An audit committee must be composed of at least three *independent directors*—that is, *outside directors* (neither officers nor employees) who have no other relationship that might impair their independence. Although audit committee members are paid for serving on the board of directors, the Sarbanes-Oxley Act of 2002 provides that audit committee members should not receive any consulting, advisory, or other compensatory fee from the company, or be in any way affiliated with the company. Also, the members of the audit committee must be financially literate, and at least one member (usually the chairman) must be a financial expert. Finally, the audit committee must be responsible for appointment, compensation, and oversight of the auditors.

In appointment and retention discussions with the audit committee, the auditors should describe any such matters that were discussed with management, including the application of accounting principles. For public companies, the auditors should discuss the conclusion from its most recent evaluation of the firm's quality control system.

During the course of the audit, the auditors will discuss with the audit committee matters such as their overall audit strategy, weaknesses in internal control, proposed audit adjustments, disagreements with management as to accounting principles, the quality of accounting principles used by the company, and indications of management fraud or other illegal acts by corporate officers (AICPA AU-C 260 and 265; PCAOB AS 1301 and 1305). Because these communications assist the audit committee in its oversight of the financial reporting process of the company, they are required by both AICPA and PCAOB standards. Chapters 7 and 16 present a detailed discussion of the required communications to audit committees.

Not all entities have audit committees. For example, the concept of an audit committee does not apply to businesses organized as sole proprietorships; partnerships; and small, closely held corporations. Arrangements for an audit of these businesses often are made with the owners, a partner, management, or the entire board of directors.

Fee Arrangements

When the business engages the services of independent public accountants, it will usually ask for an estimate of the cost of the audit. Staff time is the basic unit of measurement for audit fees. Each public accounting firm develops a per-hour or per-diem fee schedule for each category of audit staff, based on direct salaries and such related costs as payroll taxes and benefits. The direct rate is then increased for overhead costs and a profit element. In addition to standard per-diem or per-hour fees, clients are charged for direct costs incurred by the public accounting firm for staff travel, report processing, and other out-of-pocket expenditures.

Estimating a fee for an audit involves the application of the CPA firm's daily or hourly rates to the estimated time required. Because the exact number of hours cannot

be determined in advance, the auditors may merely give a rough estimate of the fee. Or they may multiply the rates by the estimated time and quote a range or bracket of amounts within which the total fee will fall. In a competitive situation, a fixed fee may be quoted that is “discounted” from the standard to meet the competition.

Communication with Predecessor Auditors

Potential successor auditors should attempt to communicate with the predecessor auditors *before accepting the engagement* (AICPA AU-C 210; PCAOB AS 2610). Because the **predecessor auditors** are an excellent source of information about a prospective client, in many circumstances this communication will occur before a formal proposal is presented to a prospective client. In other situations (e.g., the prospective client’s request or other reasons), the communication will occur subsequent to presentation of a formal proposal.

Because auditors are ethically prohibited from disclosing confidential client information without the client’s consent, the **successor auditors** must ask management of the prospective client to authorize the predecessor auditors to respond fully to the successor’s inquiries. If a prospective client is reluctant to authorize communications with the predecessor auditors, the successor auditors should seriously consider the implications in deciding whether to accept the engagement.

When permission has been granted, the successor auditors’ inquiries are aimed at matters that will assist them in determining whether to accept the engagement. The inquiries may be made orally or in writing, but either way should be documented in the auditors’ working papers. The inquiries ordinarily include obtaining information on

- Identified or suspected fraud or other noncompliance with laws or regulations.
- The integrity of management.
- Disagreements with management over accounting, auditing, or similarly significant matters.
- Understanding about the reasons for the change of auditors.
- The nature of the company’s relationships and transactions with related parties and significant unusual transactions.

This communication is extremely important because it aids the successor auditors in evaluating the *integrity of management* and other issues related to the risk of the audit. A review of cases involving management fraud reveals that in a significant number of the cases, management had recently changed the company’s auditors, often because of disagreements over accounting principles.

For public companies, there is another source of information available for investigating a change in auditors. Regulations of the SEC require companies subject to its jurisdiction to file a Form 8-K reporting changes in independent auditors and the reasons therefore. The companies also must report the details of any significant disagreements between management and the auditors occurring over the prior three years. The auditors that have resigned or been discharged must provide a response, indicating whether they agree with the company’s form and providing any necessary details. If the former client does not file Form 8-K, the CPA firm is required to report that fact to the SEC and the former client by the end of the fifth day following the end of the relationship.

The reporting requirements discourage management from the practice of **shopping for accounting principles**, in which management changes auditors to a CPA firm that is more likely to sanction a disputed accounting principle. A company’s management might, for example, search for auditors who would accept a questionable revenue recognition method as being in accordance with generally accepted accounting principles. Concern about shopping also led to the issuance of AICPA AU-C 915 (PCAOB AS 6105), which provides guidance to public accountants when they get a request for a *written or oral* report on the accounting treatment of a prospective or completed transaction from a company that is audited by another CPA firm.

Before providing a report on accounting principles, accountants should take steps to make sure they have a complete understanding of the form and substance of the transaction, including consulting with the company's current auditors. They also should review existing accounting principles and consult appropriate references and experts to provide an adequate basis for their conclusions. Although cases in which management actually shops for accounting principles are not common, it is clear that if management is allowed to change auditors casually, undue pressure is placed on auditors' objectivity.

Shopping for accounting principles is also discouraged by the provision of the Sarbanes-Oxley Act of 2002 requiring that the audit committee of a public company be responsible for the appointment, compensation, and oversight of the auditors.

Planning the Audit

LO 6-3

Explain the auditors' responsibilities when planning an audit.

Audit planning involves developing an overall audit strategy for the conduct, organization, and staffing of the audit. The nature, timing, and extent of planning vary by characteristics of the company being audited and the auditors' experience with that company. Certainly, the planning of the audit of a new client is ordinarily more difficult than the planning for a repeat client. But, for all audits, planning begins very early in the process and is iterative in that it continues throughout the audit as the auditors modify planned procedures in response to circumstances identified throughout the audit.

Establish an Understanding with the Client

The auditors should establish an understanding with the client regarding the *terms of the audit engagement*. This understanding should include (1) the objectives and scope of the audit, (2) auditor and management responsibilities, (3) inherent limitations of an audit, (4) the applicable financial reporting framework (e.g., GAAP), and (5) the expected form and content of reports to be issued by the auditors. This understanding should be in the form of a written **engagement letter** (or other suitable written agreement). When the engagement letter is accepted by the authorized client official, it presents an *executory contract* between the auditor and the client. While engagement letters do not follow a standard format, a sample engagement letter is presented in Figure 6.2.

FIGURE 6.2
Engagement Letter for
Financial Statement
Audit

Letterhead	
	September 1, 20X5
Mr. Terry Keystone, Chairman of the Board of Directors Keystone Computers & Networks Inc. 14645 40th Street Phoenix, AZ 84280	
Dear Mr. Keystone:	
[The objective and scope of the audit] You have requested that we audit the financial statements of Keystone Computers & Networks Inc. (KCN), which comprise the balance sheet as of December 31, 20X5, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter.	
The objectives of our audit are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with auditing standards generally accepted in the United States of America (GAAS) will	

always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.

[The responsibilities of the auditor]

We will conduct our audit in accordance with GAAS. As part of an audit in accordance with GAAS, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. However, we will communicate to you in writing concerning any significant deficiencies or material weaknesses in internal control relevant to the audit of the financial statements that we have identified during the audit.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as the overall presentation of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Conclude, based on the audit evidence obtained, whether there are conditions or events, considered in the aggregate, that raise substantial doubt about KCN's ability to continue as a going concern for a reasonable period of time.

Because of the inherent limitations of an audit, together with the inherent limitations of internal control, an unavoidable risk that some material misstatements may not be detected exists, even though the audit is properly planned and performed in accordance with GAAS.

[The responsibilities of management and identification of the applicable financial reporting framework]

Our audit will be conducted on the basis that management and, when appropriate, those charged with governance acknowledge and understand that they have responsibility

- a. for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America;
- b. for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; and
- c. to provide us with:
 - i. access to all information of which [management] is aware that is relevant to the preparation and fair presentation of the financial statements such as records, documentation, and other matters;
 - ii. additional information that we may request from [management] for the purpose of the audit; and
 - iii. unrestricted access to persons within KCN from whom we determine it necessary to obtain audit evidence.

As part of our audit process, we will request from management and, when appropriate, those charged with governance written confirmation concerning representations made to us in connection with the audit.

[Other relevant information]

[Insert other information, such as fee arrangements, billings, and other specific terms, as appropriate.]

[Reporting]

We will issue a written report upon completion of our audit of KCN's financial statements. Our report will be addressed to the board of directors of KCN. Circumstances may arise in which our report may differ from its expected form and content based on the results of our audit. Depending

on the nature of these circumstances, it may be necessary for us to modify our opinion, add an emphasis-of-matter paragraph or other-matter paragraph to our auditor's report, or, if necessary, withdraw from the engagement.

We also will issue a written report on [Insert appropriate reference to other auditor's reports expected to be issued.] upon completion of our audit.

Please sign and return the attached copy of this letter to indicate your acknowledgment of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.

Very truly yours,

Charles Adams

Adams, Barnes & Co.

Acknowledged and agreed on behalf of Keystone Computers & Networks by
[Signed, dated, and returned by client]

[Name and Title]

[Date]

For recurring audits, the auditors should assess whether the terms of the audit engagement need to be revised. Examples of factors that may make such revision appropriate include

- Indication that management misunderstands the objective and scope of the audit.
- A change of senior management.
- A significant change in the nature or size of the client.
- A change in reporting requirements.

For a public company client, the auditors should record the terms of the engagement annually in an engagement letter to the audit committee. For a nonpublic client, if the terms of the audit engagement do not need to be revised for the current year audit, the auditors should decide whether they wish to issue an engagement letter for the current year. Alternatively, they may remind management, in writing or orally, of the terms of the engagement and document the reminder.

Client Request to Change the Terms of an Audit

Occasionally, a client may request a change in the terms of the audit being performed. While the request may be as basic as a change in the requested date of audit fieldwork, it may be more substantial, such as a request to change the type of engagement being provided to one with a lower level of assurance (e.g., a change from an audit to a review).¹

When a request to change the terms of the audit is made by the client, the auditors should consider its reasonableness. For example, it would ordinarily be reasonable for the client to request the change based on a change in circumstances, such as a change in the requirements of the client's bank or a client's misunderstanding of the nature of an audit or a review. Regardless, in change-of-terms situations, the auditors should consider whether the change is reasonably justified and not management's attempt to limit the scope of audit procedures that may reveal financial statement misstatements.

¹ Since public companies are generally required to have audits, such changes are primarily a nonpublic company issue addressed by AICPA standards (AU-C 210; AR-C 90).

When the auditors conclude that there is no reasonable justification for the change and management will not allow continuation of the audit, they should

- Withdraw from the audit, unless prohibited by law or regulation;
- Communicate the circumstances to those charged with governance; and
- Determine whether there are legal or contractual requirements to communicate the circumstances to other parties (e.g., owners or regulators).

In addition, the auditors may wish to contact their legal counsel concerning any additional legal or contractual implications.

Develop an Overall Audit Strategy and Audit Plan

When the auditors have obtained a sufficient understanding of the client, they establish an **overall audit strategy** that considers those characteristics of the audit that determine its scope, such as industry reporting requirements, client locations, and the basis of reporting followed by the client. Issues such as timing of the audit, deadlines for reporting, and key dates that information will be received from management will be determined. Also, the auditors will make preliminary judgments on areas of high risk of material misstatement, material locations, and accounts; determine the expected approach to considering internal control; and consider recent significant client and industry factors.

When the overall audit strategy has been established, the auditors are able to start developing the **audit plan**. Although audit plans differ in form and content among public accounting firms, a plan should include a high-level description of the nature, timing, and extent of

1. Planned risk assessment procedures sufficient to assess the risks of material misstatement.
2. Planned further audit procedures for each material class of transactions, account balance, and disclosure. This includes tests of controls and substantive procedures.
3. Other audit procedures in order to comply with auditing standards.

A tentative audit plan is developed based on the auditors' initial risk assessments. This tentative plan, however, may require frequent modification as the audit progresses. For example, the nature, timing, and extent of substantive procedures are influenced by the auditors' final assessment of the risk of material misstatement. Thus, results of tests of controls affect the audit plan. Later the plan may require modification if the auditors revise their preliminary estimates of materiality or risk for the engagement, or if audit procedures disclose unexpected problems such as an additional fraud risk factor.²

Without divulging information that would affect the effectiveness of the audit, the auditors should communicate to the audit committee an overview of the overall audit strategy, including the planned scope and timing of audit procedures and significant risks identified. In addition, a number of other matters may be communicated, including the auditors'

- Plans to address significant risks;
- Approach to internal control;
- Application of the materiality concepts in the audit;
- Assessment of the nature of specialized skills needed to perform the audit; and
- Plans to use the work of internal auditors.

² Historically, the document with the detailed listing of specific audit procedures was referred to as the **audit program** (the audit plan; although the professional standards use the term *audit plan*, many use the term *audit program*), with the **audit plan** being a more general document describing the general nature, timing, and extent of audit procedures. But, at this point, AICPA, PCAOB, and international auditing standards all refer to the audit plan as including the detailed, specific audit procedures. Yet, a separate document referred to as an audit program may be used on an audit as long as it in substance includes the information required for the audit plan.



Illustrative Case

The dramatic increase in remote auditing is illustrated by a 2020 survey by the consulting firm of ConvergentCoaching. The survey results indicated

a dramatic increase in the percentage of audits, with more than 50% of the work planned to be remote, from 17% in 2018 to 61% in 2020.

Remote Auditing

Developments in information technology has facilitated the performance of many audit procedures away from the client's location, remotely. Prior to the COVID-19 pandemic, CPA firms had already begun experimenting with performing certain audit procedures remotely, but the pandemic significantly accelerated the movement.

Because the audit team can have remote access to the client's data either by directly connecting to the client's databases or obtaining electronic copies of data and files, procedures such as vouching, recalculation, reperformance, analytical procedures, and scanning may seamlessly be performed remotely. Communication tools such as Webex, Zoom, Microsoft Teams, and email can be used to facilitate remote inquiry and team meetings. There are several advantages to the use of remote auditing, including

1. Working from home or the firm's office may be more efficient than traveling to client offices, especially when the client has multiple locations.
2. The firm may have an easier time recruiting and retraining qualified and diverse professionals due to the added flexibility of the work environment.

However, these advantages do not come without some potential issues, including

1. Challenges in supervising and managing remote teams.
2. Challenges in developing relationships between staff and with client personnel.
3. Overreliance on evidence obtained from remote observations when more effective evidence could be obtained in person. As an example, consider the remote observation of inventory by the auditors. In deciding to use this approach, the auditors should consider the additional evidence that might be obtained by observing the inventory in person. For example, the auditors may be able to interact with more client personnel, which might provide insight into their understanding of the counting procedures and potential damaged merchandise.

In planning the audit, the audit team must carefully consider which procedures can effectively be performed remotely and which procedures must be performed on the client premises. It is essential that the audit be planned with the appropriate mix of remote and in-person procedures to obtain sufficient audit evidence to support the auditors' opinion.

Time Budgets

Public accounting firms usually charge clients on a time basis, and detailed time budgets can assist the auditor in estimating the audit fee. A **time budget** for an audit is constructed by estimating the time required for each step in the audit plan for each of the various levels of auditors and totaling those estimated amounts. Time budgets serve other functions in addition to providing a basis for estimating fees. The time budget communicates to the audit staff those areas the manager or partner believes are of high risk and require more time. It also is an important tool of the audit senior, who uses it to measure the efficiency of the staff and to determine at each stage of the engagement whether the work is progressing at a satisfactory rate.

There is always pressure to complete an audit within the estimated time. The staff assistant who takes more time than normal to complete a task is not likely to be popular with supervisors or to win rapid advancement. Ability to do satisfactory work when given abundant time is not a sufficient qualification, *for time is never abundant in public accounting*.

The development of time budgets is facilitated in repeat engagements by reference to the preceding year's detailed time records. Sometimes time budgets prove quite unattainable because the client's records are not in satisfactory condition or because of other special circumstances that arise. Even when time estimates are exceeded, there can be no compromise with performing the procedures with due professional care. The CPA firm's professional reputation and its legal liability to clients and third parties do not permit any shortcuts or the omission of audit procedures to meet a predetermined time estimate.

Use of the Client's Staff

The auditors should obtain an understanding with the client as to the extent to which the client's staff, including the internal auditors, can help prepare for the audit. The client's staff may prepare many audit working papers for the auditors, thus reducing the cost of the audit. Among the tasks that may be assigned to the client's employees are preparation of a trial balance of the general ledger, preparation of an aged trial balance of accounts receivable, analyses of accounts receivable written off, lists of property additions and retirements during the year, and analyses of various revenue and expense accounts. Most of these "working papers" will ordinarily be in the form of computer spreadsheets and other computerized data files marked as client prepared. Of course, if schedules are prepared by the client's staff, the auditors will test their accuracy.

Involvement of More Than One CPA Firm

When a portion of the client (e.g., a subsidiary in a distant city) is audited by another CPA firm, efforts should be coordinated. For example, if the accounts of the subsidiary are to be consolidated with the overall enterprise, and if that subsidiary is audited by another CPA firm, the auditors should coordinate the timing of necessary reports and procedures to be performed. This situation is discussed in Chapter 17.

Use of Specialists

CPAs may lack the qualifications necessary to perform certain technical tasks relating to the audit. For example, judging the valuation of a diamond inventory may require employing a specialist in gem appraisal, or evaluating the reasonableness of the fair value of a complex financial derivative instrument may require the use of a securities valuation expert. Effective planning involves arranging the appropriate use of specialists both inside and outside of the client organization. This should include consideration of the need for specialized skills in assessing the effects on the audit of the client's use of information technology. Using the work of specialists was discussed in detail in Chapter 5.

Additional First-Year Considerations

In the first audit of the client, the auditors should obtain sufficient appropriate evidence about whether the **opening balances** for the various accounts contain misstatements that materially affect the current period's financial statements. For example, consider accounts such as plant and equipment and inventories. To determine the propriety of depreciation expense for the current year and the proper balances in plant and equipment accounts at the balance sheet date, the auditors should plan to investigate the validity of the property accounts at the beginning of the current period. Similarly, if the auditors are unable to obtain satisfactory evidence as to the balance of *beginning inventories*, they may not have sufficient evidence about cost of goods sold, and it may be necessary to disclaim an opinion on the income statement.

Auditors are required to determine whether the prior period's closing balances were properly brought forward to the current period, and whether those balances reflect the

application of appropriate accounting policies (AICPA AU-C 510; PCAOB 2610). When satisfactory prior-year audits of the business have been performed by predecessor auditors, as discussed earlier, the successor auditors will ordinarily have communicated with the predecessor about matters such as management integrity, disagreements that the predecessor may have had with management, communications with the audit committee, and the predecessor's understanding of the reason for the change of auditors. Auditors also ordinarily initiate a second communication with the predecessor auditors subsequent to acceptance of the new client. This second communication relates primarily to the contents of the predecessor auditors' working papers related to opening balances and the consistency of application of accounting principles. In addition to reviewing the predecessor auditors' working papers relating to opening balances, the successor auditors will evaluate whether audit procedures planned for the current audit will provide evidence about the opening balances. Based on this evaluation, the successor auditors will decide whether it is necessary to perform additional procedures specifically designed to obtain evidence regarding the opening balances.

In cases in which no satisfactory recent audit has been performed, an extensive analysis of transactions of prior years will be necessary to establish account balances as of the beginning of the current year.

Obtaining an Understanding of the Client and Its Environment

LO 6-4

Describe the nature of the risk assessment procedures that auditors use to obtain an understanding of the client and its environment.

The required understanding of the client is used by the auditors to help plan the audit and to assess the risks of material misstatement at the financial statement and assertion levels. Guidance on obtaining this required understanding of the client is contained in AICPA AU-C 315 and PCAOB AS 2110.

Risk Assessment Procedures

To obtain the understanding of the entity and its environment, auditors perform risk assessment procedures, which include

- Inquiries of management and others within the entity.
- Analytical procedures.
- Observation and inspection relating to client activities, operations, documents, reports, and premises.
- Procedures such as making inquiries of others outside the company (e.g., legal counsel, valuation experts) and reviewing information from external sources (e.g., analysts, banks, rating organizations, and business and industry publications).
- When available, information obtained from experience with the client (e.g., from a previous year's audit or other services provided). In such a situation, auditors should evaluate whether such information remains relevant and reliable as audit evidence for the current audit.

These risk assessment procedures help auditors to identify risks of material misstatement and are supplemented by further audit procedures in the form of tests of controls and substantive procedures to obtain sufficient audit evidence to express an opinion on the financial statements.

Information on the Client's Business and Its Environment

When should a health club recognize its revenue from the sale of lifetime memberships? Is a company organized to produce a single motion picture a going concern? What basis should be used to record a barter of goods over the **Internet**? What is a reasonable depreciable life for today's most advanced information systems? We will not attempt to answer these questions in this textbook; we raise them simply to demonstrate that the auditors should obtain a good working knowledge of an audit client's business and its environment

if they are to design effective audit procedures. An understanding of the client and its environment encompasses

- The nature of the client, including the client's application of accounting policies.
- The industry, regulatory, and other external factors affecting the client.
- The client's objectives and strategies and related business risks.
- Methods used by the client to measure and review performance.
- The client's internal control.

Performing procedures to obtain an understanding of the entity and its environment is an essential part of planning and performing an audit. Specifically, the understanding establishes a frame of reference for the auditors to use in (1) considering the appropriateness of the accounting policies applied by the client, (2) identifying areas where special audit consideration may be necessary (specialized risks), (3) establishing appropriate materiality, (4) developing expectations for analytical procedures, (5) designing and performing audit procedures, and (6) evaluating audit evidence.

The Nature of the Client

What is the client's business model? Who are its major customers and suppliers? What types of transactions does the client engage in? How are they accounted for? These are the types of questions that the auditors attempt to answer to obtain an understanding of the nature of the client. The auditors' understanding of the nature of the client will include the client's competitive position, organizational structure, governance processes, accounting policies and procedures, ownership, capital structure, and product lines. Then the auditors turn their attention to the client's critical business processes and obtain an understanding of how these processes create value for the client's customers. **Business processes** relevant to financial reporting include the activities designed to

- Develop, purchase, produce, sell and distribute the organization's products and services;
- Record information, including accounting and financial information; and
- Ensure compliance with laws and regulations.

Industry, Regulatory, and Other External Factors

The factors envisioned here include industry conditions, such as the competitive environment, supplier and customer relationships, and technological developments. They also include the regulatory, legal, and political environment and general economic conditions. These factors may subject the client to specialized risks that in turn may affect the audit. Many firms—including the Big 4 firms to varying degrees—have adopted a financial model to evaluate the client's industry that considers the attractiveness and other characteristics of the industry. Concerning the *overall attractiveness of the industry*, auditors consider such factors as

- Barriers to entry.
- Strength of competitors.
- Bargaining power of suppliers of raw materials and labor.
- Bargaining power of customers.

The other *characteristics of the client's industry* that auditors consider include factors such as economic conditions and financial trends, governmental regulations, changes in technology, and widely used accounting methods.

Objectives and Strategies and Related Business Risks

The client's objectives are the overall plans of the entity as defined by management. Management attempts to achieve these objectives by developing strategies, or operational actions. However, achieving management's objectives is always subject

to business risks. As described in the previous section, these are the conditions that threaten management's ability to execute strategies and achieve objectives. The auditors obtain an understanding of the client's operating and financing strategies and attempt to identify significant business risks faced by the client. Risks that may be identified for a particular client might include risks related to competition, changes in government regulations, changes in technology, volatility of raw materials prices, interruption of supplies of critical raw materials, changes in major markets, or increases in interest rates. In obtaining their understanding of these matters, the auditors are particularly interested in management's risk assessment process. Well-operated companies use formal processes for identifying business risks and devising ways to mitigate them. An understanding of this process can assist the auditors in identifying business risks and evaluating their audit significance. Many of these business risks may create risks of material misstatement of the financial statements.

Methods of Measuring and Reviewing Performance

Management may use a variety of techniques to measure and review performance, such as budgets, key performance indicators, variance analysis, and segment performance reports. Many firms use a *balanced scorecard* that combines a number of financial and nonfinancial performance measures to assess the financial, customer, internal business process, and learning and growth perspectives of the organization. These measurement systems assist management in gauging progress toward meeting its objectives. External parties also may measure and review the client's performance. Examples include bond rating agencies, credit agencies, and financial analysts. The methods of measuring and reviewing performance are important to the auditors in determining the incentives of management and other employees because their compensation is often tied to the measures. These incentives may create pressure on management or employees to misstate the financial statements or otherwise engage in fraud. In addition, the auditors may use these measures in designing analytical procedures to provide evidence about the fairness of the financial statements.

Internal Control

Internal control is designed to provide reasonable assurance of achieving objectives related to reliable financial reporting, efficiency and effectiveness of operations, and compliance with applicable laws and regulations. The nature and extent of the audit work to be performed on a particular engagement depend largely upon the effectiveness of the client's internal control in preventing or detecting material misstatements in the financial statements. Before auditors can evaluate the effectiveness of internal control, they need a knowledge and understanding of how it works: what controls exist and who performs them, how various types of transactions are processed and recorded, and what accounting records and supporting documentation exist. The auditors should have a sufficient understanding of the design and implementation of internal control to plan the audit. Chapter 7 focuses on the auditors' consideration of internal control.

Sources of Information

Much information about the nature of the client may be obtained through inquiries of management and other personnel. For example, the auditors may use inquiry to determine the major types of sales transactions and the nature of the client's customers. The auditors may combine inquiry and inspection to determine the content of sales contracts and the accounting policies used for recognizing revenues under the contracts. They also make inquiries of other personnel within the organization. As an example, production personnel can provide the auditors with a more detailed understanding of production processes. In addition, informal discussions between the auditors and key officers of the client can provide information about the history, size, operations, accounting records, and internal control of the enterprise. When making inquiries, the auditors should analyze the responses obtained for consistency and ask relevant follow-up questions to better understand the topics being considered and the perspectives and motivations of those interviewed.



Illustrative Case

The Importance of Understanding the Client's Business

The importance of an understanding of the client's business was dramatically illustrated by the Volkswagen AG case. In this case, the company reported that "criminal manipulation" of its foreign-exchange positions had cost the firm as much as \$259 million. The fraud prompted the

resignation of the company's chief financial officer and the firing of its foreign-exchange manager. The auditors did not detect the fraud until fraudulent contracts came due and were rejected by banks. An insider suggested that auditors often don't know enough about complicated currency instruments to detect such problems.

Many other sources of information on clients are available to the auditors. For example, the PCAOB issues *Staff Audit Practice Alerts*, *Staff Questions and Answers*, and *Staff Guidance* on a variety of topics. AICPA *Audit and Accounting Guides*, AICPA *Industry Risk Alerts*, AICPA *Industry-Specific Risk Assessment Practice Aids*, trade publications, and governmental agency publications are useful in obtaining an orientation to the client's industry. Previous audit reports, annual reports to stockholders, SEC filings, and prior years' tax returns are excellent sources of financial background information.

Online Research

The Internet makes any number of sources of electronic information available about clients, particularly clients that are public companies. Information about corporations is generally available from a variety of sources, including from the corporation's home page, brokerage companies, SEC filings, and other financial information providers. In addition, Internet search engines, such as Google or Bing, can be used to identify journal and news stories on the client. Recall that Appendix 5A is a listing of some Internet addresses that may be helpful in performing accounting and auditing research.

Tour of Plant and Offices

Another useful preliminary step for the auditors is to arrange an inspection tour of the plant and offices of a prospective client. This tour will give the auditors some understanding of the plant layout, manufacturing process, principal products, and physical safeguards surrounding inventories. During the tour, the auditors should be alert for signs of potential problems. Rust on equipment may indicate that plant assets have been idle; excessive dust on raw materials or finished goods may indicate a problem of obsolescence. A knowledge of the physical facilities will assist the auditors in planning how many audit staff members will be needed to participate in observing the physical inventory.

The tour affords the auditors an opportunity to observe firsthand what types of information technology and internal documentation are used to record such activities as receiving raw materials, transferring materials into production, and shipping finished goods to customers. An understanding of these computer applications and documentation is essential to the auditors' consideration of internal control. Inquiries of personnel in various departments may provide the auditors with critical information about the client's operations and may serve to confirm information obtained from financial management.

In visiting office areas, the auditors will learn the location of various facilities and accounting records. The auditors can ascertain the practical extent of segregation of duties within the client organization by observing the number of office employees. In addition, the tour will afford an opportunity to meet the key personnel whose names appear on the organization chart. The auditors will record the background information about the client in a *permanent file* available for reference in future engagements.

Analytical Procedures

As described in Chapter 5, **analytical procedures** involve comparisons of financial statement balances and ratios for the period under audit with auditor expectations developed

from sources such as the client's prior years' financial statements, published industry statistics, and budgets. When used for risk assessment purposes, analytical procedures assist the auditors in *planning* the nature, timing, and extent of audit procedures that will be used for the specific accounts. The approach utilized is one of using the procedures to identify results that differ significantly from the auditors' expectations and may, therefore, represent higher risks of material misstatement. The auditors will then plan a more thorough investigation of the related accounts, transactions, or disclosures. Auditors are required to perform analytical procedures as a part of the risk assessment process for *every* audit.

An example of the use of an analytical procedure for risk assessment purposes is the comparison of the client's inventory turnover for the current year with comparable statistics from prior years. A significant decrease in inventory turnover might lead the auditors to consider the possibility that the client has excessive amounts of inventory. As a result, the auditors would plan more extensive procedures to search for inventory items that may be obsolete.

The Statement of Cash Flows and Obtaining an Understanding of the Client

The auditors may use the statement of cash flows to analyze cash flows while obtaining an understanding of the client, particularly as a part of risk assessment analytical procedures. For a profitable, growing company, one ordinarily expects positive operating cash flows, perhaps slightly higher than net income due to the adding back to net income of noncash expenses such as depreciation and amortization items. Cash flows from investing are often negative for such a company as it makes capital expenditures and investments. The direction of cash flows from financing is expected to vary among years depending upon issuance and redemption of stock and debt.

Continuing with the example of a profitable, growing company, when the auditors find that cash from operations is significantly less than net income, investigation of the reason or reasons is appropriate. Possible reasons include large increases in current assets (e.g., accounts receivable and inventory) and decreases in liabilities (e.g., accounts payable), and recognition of large amounts of revenues for which no cash has been received. While such conditions may or may not indicate a misstatement, they are worthy of follow-up and explanation.

Determining Materiality

The concept of **materiality** recognizes that some matters are important to the fair presentation of financial statements, while others are not. Materiality is basic to financial statement auditing because an audit is performed to obtain reasonable assurance about whether the financial statements are free of *material* misstatement. Accordingly, auditors should plan and perform audit procedures to detect misstatements that individually or in combination with other misstatements would result in material misstatement of the financial statements.

Materiality judgments depend both upon the financial reporting framework being used and on the auditors' professional judgment. Relating to generally accepted accounting principles, *FASB Statement of Financial Accounting Concepts No. 8* (as revised in 2018) states:

The omission or misstatement of an item in a financial report is material if, in light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.

PCAOB AS 2105 points out that in interpreting the federal securities laws, the Supreme Court of the United States in the case of *TSC Industries v. Northway, Inc.* (426 U.S. 438, 449 [1976]) held that a fact is material if there is

a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

AICPA AU-C 320 indicates that misstatements, including omissions, are material if there is

a substantial likelihood that, individually or in the aggregate, they reasonably would influence the judgment made by a reasonable user based on the financial statements.

While not identical, the descriptions are very similar. It is important to realize that they all involve a consideration of quantitative and qualitative factors—particularly when evaluating a misstatement that has been identified. Under certain circumstances, a misstatement that would ordinarily be considered immaterial in quantitative terms may be material because of its qualitative nature. As an example, an illegal payment of an otherwise immaterial amount could be material if there is a **reasonable possibility** that it would lead to a material contingent liability or a material loss of revenue.

Auditors consider materiality both in planning the audit and in evaluating audit findings. In *planning* the audit, auditors use materiality as an input into determining the proper scope of audit procedures to obtain reasonable assurance of detecting material misstatements in the financial statements.

In *evaluating* audit findings, the auditors use materiality to evaluate whether identified uncorrected misstatements (plus an allowance for undetected misstatements) are material to the financial statements. This is a critical decision because materially misstated financial statements should result in audit opinion modification, while immaterially misstated financial statements should not. Because this chapter emphasizes planning, we will emphasize materiality in planning the audit, but we also will provide a brief discussion of materiality for evaluation purposes. Materiality for evaluation purposes is also addressed in Chapter 16.

Considering Materiality in Planning the Audit

The auditors' consideration of materiality at the planning stage of the audit helps them to determine the appropriate scope of their audit procedures. They first consider materiality at the level of the financial statements as a whole. Then, for account balances, classes of transactions and disclosures for which misstatements of a lesser amount would influence the decisions of users, they establish lower materiality levels.

Audit procedures should be designed to detect misstatements that, in combination, could be material to the financial statements so that the auditors do not waste time searching for clearly immaterial misstatements that cannot affect the auditors' report. As described in Chapter 5, the scope of the auditors' procedures for an account is directly related to the risk of material misstatement of that account. The auditors will perform extensive procedures on an account with a high risk of material misstatement. Limited or no audit procedures will be performed on an account that is extremely small and financially inconsequential, unless, based on qualitative considerations, the account is significant. For example, an Accounts Receivable from Officers account might be considered material regardless of its size.

While planning the audit, the auditors may become aware of a number of accounting expediciencies followed by the client that may result in immaterial misstatements. The concept of materiality often allows auditors to "pass over" certain conceptual accounting errors, such as charging low-cost items like small tools or business machines directly to expense accounts. But even in these situations, the auditors need to carefully consider the possibility that the effect of such accounting expediciencies may differ materially from results obtained following generally accepted accounting principles. Accounting expediciencies are not acceptable simply because the client's management says the amounts involved are immaterial or because the amounts involved were considered immaterial in the past.

Materiality and the Scope of Audit Procedures

As implied in the preceding illustration, *increases* in the amount of materiality result in *decreases* in the scope of audit procedures. For example, all things being equal, auditors will gather less audit evidence if materiality is \$500,000 as compared to \$100,000. The relationship is that as materiality increases, the auditors will need less evidence because their audit is based on a less precise measure. Thus, if income is approximately \$5,000,000, it will take less audit effort to be able to conclude that misstatements do not exceed \$500,000 than to conclude that they do not exceed \$100,000.

Quantifying Materiality for the Financial Statement as a Whole

In concept, materiality is a matter of professional judgment based on the auditor's perception of the needs of users of the financial statements. It is the maximum aggregate value of misstatement that can exist without affecting the audit opinion, given the desired level of audit risk.

Auditing standards require that auditors determine materiality for the financial statements as a whole (also referred to as overall financial statement materiality, or overall materiality). Auditors may use *rules of thumb* related to a financial statement base—such as net income, total revenues, or total assets—to develop these estimates of materiality. Rules of thumb that are commonly used in practice include

- 5 percent to 10 percent of net income before taxes.
- ½ percent to 1 percent of total assets.
- ½ percent to 1 percent of total revenues.
- 1 percent of total equity.

The appropriate financial statement base for computing materiality will vary based on the nature of the client's business. For example, total revenues for a financial institution are often too small to use as the base in conjunction with the percentages presented above. In addition, if a company is in a near break-even position, net income for the year will be much too small to be used as the financial statement base. In that situation, the auditors often will choose another financial statement base or use an average of net income over a number of prior years.³

Audits are designed to identify materially misstated financial statements, whether caused by one or more *individually material misstatements* or by a *combination of individually immaterial misstatements*. For example, in an audit with a \$100,000 overall financial statement materiality level, two individually immaterial misstatements of \$70,000 may in total materially misstate financial statements by \$140,000, just as a single material misstatement for \$140,000 would.

Statements on Auditing Standards and *International Auditing Standards* present the concept of **performance materiality**. This concept was introduced, in part, to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected immaterial misstatements in the financial statements would exceed overall financial statement materiality. As is discussed in more detail in the next section, performance materiality is established at an amount or amounts set by the auditor at less than materiality for the financial statements as a whole.

Quantifying Materiality for Individual Accounts, Classes of Transactions, and Disclosures

As indicated earlier, qualitative characteristics of certain smaller misstatements may make them influence the judgment of users, and thereby make a lower quantitative amount become material for certain accounts, class of transactions, or disclosures. Examples include certain related party transactions, remuneration of management, research and development costs of extreme importance to a particular company, and particularly key assets for a company. One approach to addressing this situation is to use the performance materiality concept described in the preceding section to adjust the overall financial statement materiality amount to smaller performance amounts for these accounts, class of transactions, and disclosures.

How do auditors establish performance materiality? Because there are no specific formulas to derive the amount, auditors must use their professional judgment in the process.

³ An audit firm may arrive at differing amounts for individual financial statements. As an example, the auditors may conclude that a \$100,000 misstatement of net income before taxes is material for purposes of the income statement, and a \$200,000 balance sheet misstatement is material. Because many possible misstatements affect both the balance sheet and the income statement (e.g., a credit sale affects both accounts receivable on the balance sheet and sales on the income statement), the auditors will design their audit to detect the smallest misstatement that would be material to any one of the financial statements, in this case \$100,000.



Illustrative Case

Example of the Relationships among Materiality, Performance Materiality, and Tolerable Misstatement



Assume, in their audit of inventory balances, the auditors plan to perform several procedures related to the overall balance. Tests will be applied to the (1) physical existence of inventory quantities, (2) costs of inventory items, and (3) possible need for a write-down for obsolescence. The auditors use materiality for the financial statements as a whole to establish performance materiality, which in turn is used to establish the tolerable misstatement amount for various tests of accounts and balances, as described below:

- Materiality for the financial statements as a whole for planning purposes of the audit is set at \$100,000 (e.g., either by directly considering the amount that would create a substantial likelihood of influencing the judgment made by a reasonable user of the financial statements or by using a rule of thumb).
- Performance materiality is established at \$70,000 for the overall inventory account because several accounts immaterially misstated may in total lead to a material misstatement of the financial statements. For example, the auditors wish to control the possibility that two immaterial misstatements exist and combine to materially misstate the financial statements by more than \$100,000.
- Tolerable misstatement is established at \$60,000 for each of the tests to provide some assurance that the combined test results will provide the desired assurance that performance materiality has not been exceeded. Depending upon underlying characteristics of the populations, differing tolerable misstatements could be established.

While a number of approaches are available, a frequently used method is to use a range between 50 and 75 percent of overall financial statement materiality, depending on the risk of material misstatement associated with a *particular account, class of transactions, or disclosure item*. For example, a lower percentage would be used for an account whose misstatement is believed to influence financial statement users at a lower amount.

Finally, the auditors may determine **tolerable misstatement**, which may be viewed as the application of performance materiality to a *particular audit procedure*. Tolerable misstatement may be the same amount or lower than performance materiality depending upon the audit sampling technique being used and the nature and number of audit procedures performed for the **relevant assertions**.⁴ Chapter 9 illustrates how tolerable misstatement is used in the calculation of sample sizes for substantive procedures that involve audit sampling.

The following illustrative case, adapted from the AICPA Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit*, distinguishes among materiality for the financial statements as a whole for planning purposes, performance materiality, and tolerable misstatement.

Chapter 9 illustrates how tolerable misstatement is used in conjunction with substantive procedures using various audit sampling techniques.

Determining Materiality for Evaluation

Throughout the audit, auditors accumulate misstatements that are identified, excluding only those that are considered clearly trivial. Then, the auditors typically request management to correct the misstatements. If management refuses, the concept of materiality for evaluation purposes comes into play. The auditors' approach is to first consider whether the total of the misstatements identified, plus an allowance for undetected misstatements, is quantitatively material. Here the auditors should consider all uncorrected misstatements, including the projected misstatement resulting from sampling. As an example of projected misstatement, if the auditors test 10 percent of a population and find a \$5,000

⁴ PCAOB *Auditing Standards* do not explicitly include the performance materiality concept, but use tolerable misstatement to include the disaggregated planning materiality amount both for accounts and for individual audit tests. PCAOB standards acknowledge that lower materiality levels may be appropriate for certain accounts and disclosures.

misstatement, they would estimate that the entire population is misstated by about \$50,000 ($\$5,000 \div 10\%$).⁵ Rules-of-thumb materiality amounts applied for planning purposes are often used in this quantitative analysis. If the auditors believe that the estimated amount of misstatement is not quantitatively material, they should still consider whether either possible undetected misstatements or qualitative factors could result in the financial statements being materially misstated—this is discussed further in Chapter 16.

Qualitative Considerations of Materiality

As we've discussed, qualitative factors are particularly significant to materiality when one is evaluating results of audit procedures. Thus, for example, related party transactions of relatively small amounts might be considered material to the company's financial statements. Examples of other factors that may make an item qualitatively material include the following:

- A misstatement of the financial statements that would affect a company's compliance with a contractual agreement might be material regardless of its amount. As an illustration, assume that a company's long-term debt agreement requires the company to maintain working capital of at least \$500,000; otherwise, the total debt becomes payable upon demand. If the company's working capital on the balance sheet is only slightly more than \$500,000, a small misstatement might disguise a violation of the debt agreement. Because the violation would mean that the company's long-term debt should be reclassified as a current liability, the small misstatement becomes material to the financial statements.
- A misstatement that would cause a company not to make the consensus earnings-per-share estimate of financial analysts might be considered material even though it is somewhat less than what would normally be considered material.

Considering materiality when evaluating results and the overall process of evaluating audit procedures are described in greater detail in Chapter 16.

Assessing the Risks of Material Misstatement and Designing Further Audit Procedures

LO 6-5

Describe the process by which auditors assess the risks of material misstatement in the financial statements.

As discussed in Chapter 5, the term **audit risk** refers to the possibility that the auditors express an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risk of material misstatement and detection risk.⁶ Auditors are aware that few audits involve material misstatements of financial statements, but when such misstatements do exist, they can result in millions of dollars of losses to investors and potential liability to the auditors. Experience has shown that many undetected material misstatements of financial statements are intentional fraud, rather than unintentional errors.

Assessing Risks of Material Misstatement

The auditors should plan and perform the audit to obtain reasonable assurance that material misstatements, whether caused by errors or fraud, are detected. Accordingly, in designing an audit, the auditors should identify and assess the risks of material misstatement of the financial statements and design audit procedures in response to the risks.

While the professional standards do not require a particular audit methodology in identifying the risks of material misstatement, auditors often apply a "top-down" approach. That approach involves starting on "top" by analyzing the financial statements and their accounts and identifying particular accounts that have potential risks of material misstatement. Each account with an identified risk of material misstatement (i.e., its likelihood of occurrence is more than remote when considering inherent risk) is matched

⁵ The topics of projection of misstatements and evaluating overall audit findings are discussed in Chapters 9 and 16.

⁶ Recall from Chapter 5 that at the assertion level, the risks of material misstatement are composed of inherent risk and control risk.

“down” to relevant assertion or assertions. Financial statement accounts (“line items”) can be aggregated or disaggregated as considered appropriate for a particular client.

A related, although somewhat different approach for identifying the risks of material misstatement is to begin with transaction classes (e.g., purchases, cash disbursements) and work down to financial statement assertions. Using either approach (or a combination thereof), the process may be viewed as including the following stages:

- *Identify risks of material misstatement by performing risk assessment procedures* while obtaining an understanding of the entity including internal control and considering characteristics of the account balances, classes of transactions, and disclosures.
- *Assess identified risks of material misstatement at the financial statement level* and evaluate their pervasive effects on the financial statements and whether identified risks affect specific financial statement assertions.
- *Assess identified risks of material misstatement at the assertion level* by identifying risks related to relevant assertions about account balances, classes of transactions, and disclosures and then considering control risk using the auditors’ understanding of internal control and planned tests of operating effectiveness.
- *Design further audit procedures (tests of controls and substantive procedures) in response to the identified risks of material misstatement.* The nature, timing, and extent of the tests should be based on the assessed risks of material misstatement and should be designed to obtain sufficient appropriate audit evidence.

In practice, the findings at the various stages affect one another. The entire risk assessment process is best viewed as iterative and dynamic in that expectations of risks and required further audit procedures may be developed and further refined as the auditors progress through the audit.

The auditors try to relate each identified risk to “what can go wrong” regarding the set of financial statements and its assertions. As an example, if the auditors identify a risk of inventory obsolescence, this translates to a risk that inventory may be misstated with respect to the valuation assertion. Next, the auditors consider whether this risk could result in a material misstatement of inventory and cost of goods sold and the likelihood that the material misstatement could actually occur. Finally, they use all of this information to plan and perform the audit.

In performing the risk assessment, it is important for the auditors to recognize that risks of material misstatement occur at both (1) the financial statement level and (2) the assertion level for account balances, classes of transactions, and disclosures. These two levels of risks may affect the audit in different ways.

Assessing Risks at the Financial Statement Level

Risks at the financial statement level are those that relate to the overall financial statements and potentially affect many individual accounts and assertions. The following examples help to illustrate financial statement level risks:

- Concerns about the integrity of management, including its *possible* override of controls.
- Complex financial structure, including business combinations with complex consolidation issues.
- Going concern issues, including a lack of sufficient capital to continue operations.
- Declining industry.
- Risks related to the selection and application of significant accounting policies.

Auditors generally respond to financial statement risks by making alterations in the overall approach to the audit. Appropriate responses to financial statement level risks include

1. Assigning to the audit more experienced staff or individuals with specialized skills.
2. Providing more supervision for the audit staff and emphasizing the need for them to maintain an attitude of professional skepticism.

3. Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
4. Increasing the overall scope of audit procedures.

Assessing Inherent Risks at the Assertion Level

Most risks of misstatement involve relevant assertions that relate to one or more significant account balances, classes of transactions, or disclosures. Recall from Chapter 5 that a relevant assertion is one that has a reasonable possibility of containing a material misstatement without considering controls. Similarly, a significant account, class of transactions, or disclosure is one that has one or more relevant assertions. Recall that we have summarized these assertions as

1. Existence and occurrence.
2. Rights and obligations.
3. Completeness.
4. Cutoff.
5. Valuation, allocation, and accuracy.
6. Presentation and disclosure.

In assessing inherent risk, auditors consider qualitative and quantitative **inherent risk factors** such as the following that may affect the likelihood or magnitude of misstatements that may occur:

- *Complexity* due to factors such as regulatory requirements, a complex business model, or the nature of transactions.
- *Subjectivity* arising from subjective valuations of transactions, balances, or disclosures, such as the use of complex accounting estimates.
- *Changes* arising from factors such as changes in economic conditions, loss of customers, or application of new accounting pronouncements.
- *Uncertainty* arising from conditions such as pending litigation or other contingent liabilities.
- *Susceptibility to misstatement due to management bias or other fraud risk factors* as indicated by conditions such as significant management incentives to overstate profits or significant related party transactions.
- *Other factors*, including the quantitative or qualitative significance of certain transactions, accounts, or disclosures, or lack of uniformity in composition of items.

When assessing inherent risk, both the PCAOB and the AICPA standards require consideration of both the *likelihood* of a misstatement occurring and its *magnitude*. In considering the magnitude, the auditors consider both the quantitative and the qualitative aspects of the possible misstatement, including the size, nature, or circumstances involved.

The AICPA includes misstatement likelihood and magnitude in its **spectrum of inherent risk**. The level of inherent risk varies on the spectrum of inherent risk based on the auditors' assessment of inherent risk factors. The spectrum provides a frame of reference to help auditors determine the significance of the combination of the likelihood and magnitude of a misstatement.

As an example, consider the risk related to inaccurate counting of inventory at year-end, which affects the valuation of inventory and the accuracy of cost of goods sold. For this type of risk, the auditors consider the risk and assess the magnitude and likelihood of the risk for each of the relevant assertions. Finally, they will adjust the nature, timing, or extent of the audit procedures designed to test controls or detect the misstatement. If the auditors conclude there is an increased risk of material misstatement of the financial statements due to inaccurate inventory counting, they may decide to assign more experienced audit staff members (and possibly more staff members) to observe the inventory count by client personnel.



Illustrative Case

Two Approaches to Assessing the Risks of Material Misstatement

The following case compares the two approaches to assessing the risks of material misstatement for a hypothetical account type, class of transaction, or disclosure. Recall from Chapter 5 that assessments may be in quantitative terms or in nonquantitative terms. In this case, we use nonquantitative terms. Note that a wide variety of working papers would support the chosen method.

Relevant Assertion	Inherent Risk	Control Risk	Risk of Material Misstatement	Audit Approach
Existence	High	Low	Moderate	(Description)
Completeness	Moderate	High*	Moderate	(Description)
Cutoff	Moderate	Low	Low	(Description)

*No tests of control performed.

Two approaches for assessing the risk of material misstatement:

1. Overall Assessment Approach: The auditors are not required to consider Inherent Risk and Control Risk separately and are only required to document the overall assessment of the Risk of Material Misstatement column.
2. Separate Assessment Approach: The auditors consider both the Inherent Risk and Control Risk columns separately and have the option of documenting the overall assessment of the Risk of Material Misstatement column.

Assessing Control Risk

After assessing inherent risks, or in conjunction with their assessment of inherent risks, the auditors will assess the impact of internal control. Similar to inherent risks, certain control risks may have an effect on many financial statement assertions. For example, a weak control environment may have an impact on a number of assertions about a number of financial statement accounts, classes of transactions, and disclosures. Other internal controls affect only one or a few financial statement assertions. In order to reduce the overall risk of material misstatement of an assertion, the auditors must design tests of controls to obtain evidence that the controls are operating effectively.

As discussed in Chapter 5, after significant account balances, classes of transactions, and disclosures and their relevant assertions have been identified, the auditors may take one of two possible approaches to assessing the risks of material misstatement. They may decide to make a direct, overall assessment of the risk of material misstatement for each of the various relevant assertions, or they may decide to make separate assessments of inherent and control risk for those assertions. PCAOB standards (AU 2110) allow either approach, while AICPA standards (AU-C 315) require separate assessments (although the risks may be combined after they are separately assessed). The following illustrative case describes the two different approaches.

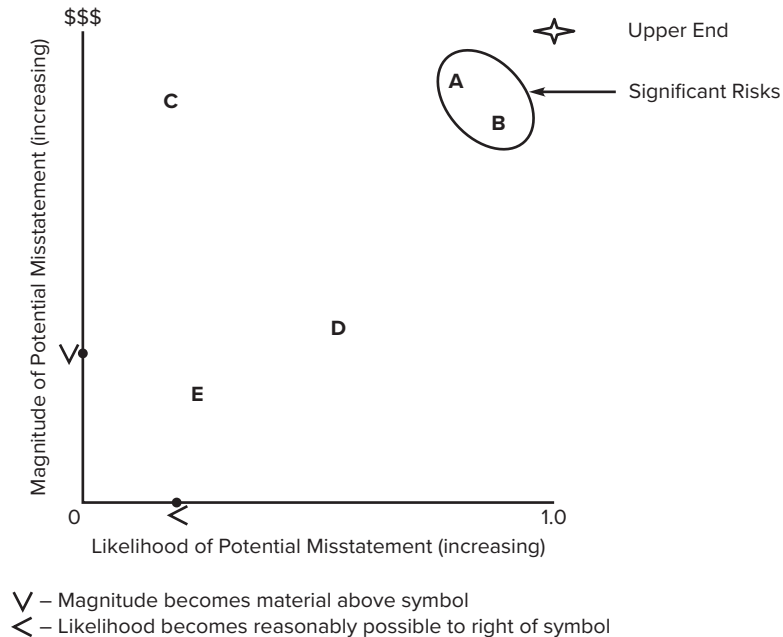
Significant Risks

While assessing risks, auditors should determine which of the identified risks have a very high inherent risk and require special audit consideration. Such a risk is referred to as a **significant risk**. One or more significant risks arise on most audits. In determining whether a risk is a significant risk, the auditors consider its inherent risk without considering the client's related controls. Significant risks have a very high inherent risk, based on the auditors' professional judgment of the combination of the *likelihood* of occurrence and its potential *magnitude*. The AICPA describes significant risks as being close to the upper end of the spectrum of inherent risk. Also, the risks related to fraud and certain related party transactions are always treated as significant risks in accordance with the professional standards.⁷

⁷ Fraud risks and certain related party transactions are considered significant risks (AICPA AU-C 240, 315, and 550; PCAOB AS 2110). Also, AU-C 315 and PCAOB AS 2110 present further specific details on significant risks.

FIGURE 6.3
Illustration: Spectrum of
Inherent Risk*

*Letters represent risks of material misstatement for the assertions A through E.



In considering whether an identified risk of material misstatement is close to the upper end of the spectrum of inherent risk and constitutes a significant risk, the auditors analyze the inherent risk factors presented earlier in this chapter. Those factors include complexity, subjectivity, change, uncertainty, and susceptibility to misstatement due to management bias or other fraud risk factors. Figure 6.3 illustrates the spectrum of inherent risk and its dimensions of magnitude and likelihood. Assume in this illustration that risks of material misstatement relating to assertions A and B are circled because the auditors consider them “close to the upper end” of the spectrum and therefore significant risks.⁸

In Chapter 5, we distinguished among routine, nonroutine, and estimation transactions. Significant risks often relate to nonroutine and estimation transactions. For example, estimates of the value of a significant inventory of precious metals or gems might represent a significant risk in an audit of a chain of jewelry stores. In other businesses, such risks may arise due to critical accruals and various other estimates that must be subjectively determined by management. Also, assessed risks of material misstatement due to fraud are always considered significant risks (e.g., the risk of fraudulent revenue recognition).

The audit approach for significant risks involves careful consideration of the design and implementation of the related controls and appropriate substantive procedures. Depending upon the circumstances, tests of control may be performed. Both AICPA and PCAOB standards require auditors to perform substantive procedures for all significant risks, although the AICPA suggests that in certain circumstances substantive analytical procedures may be sufficient. The PCAOB requires the auditors to perform substantive procedures that involve tests of details for all significant risks.

As indicated above, risks of material misstatement due to fraud always represent significant risks. Because of the importance and unique nature of fraud, the professional standards provide more specific guidance for the auditors in assessing the risks of material misstatement of the financial statements due to *fraud* (AICPA AU-C 240; PCAOB AS 2401).

⁸ See AICPA AU-C 240, 315, and 550 and PCAOB AS 2110. Also, AU-C 315 and PCAOB AS 2110 present further specific details on significant risks.



Illustrative Case

Litigation and Management Fraud

An analysis of SEC enforcement cases involving fraud reported that in 89 percent of cases, the CEO and/or the CFO in the company was named in the fraud. Misappropriation of assets was indicated in only 14 percent of the cases. In a vast majority of the cases,

management engaged in fraudulent financial reporting motivated by such factors as meeting analysts' earnings expectations, concealing deteriorating financial conditions, and preparing for debt or equity offerings. Finally, revenue frauds accounted for over 60 percent of the cases.⁹

Addressing the Risks of Material Misstatement Due to Fraud



LO 6-6

Describe how the auditors address fraud risk.

The auditors' consideration of risks of material misstatement from fraud recognizes that there are two distinct types: (1) misstatements arising from **fraudulent financial reporting (management fraud)** and (2) misstatements arising from **misappropriation of assets (defalcations)**. The auditors' fraud risk assessment involves identifying risks of material misstatement of the financial statements due to fraud and determining the appropriate audit response. To identify fraud risks, the auditors perform a number of procedures, including having discussions with engagement personnel, making inquiries of management and others within the organization, performing analytical procedures, and considering fraud risk factors.

Discussions with Engagement Personnel

Both AICPA and PCAOB standards require the auditors to have a discussion with the audit team members about the susceptibility of the client's financial statements to material misstatements, including a brainstorming session on the susceptibility of the financial statements to material misstatements due to fraud. These discussions allow the more experienced team members to share insights and exchange ideas about how and where the entity's financial statements might be susceptible to material misstatement—due to either error or fraud—and to emphasize the importance of maintaining the proper degree of professional skepticism regarding the possibility of such misstatements. The discussion also will review errors that are expected to occur based on the results of prior audits. The discussion should involve the auditor with final responsibility for the audit (the engagement partner) and other key members of the audit team. Although having all team members present may often be possible and desirable, it is not required. Professional judgment also is used in determining how and when the discussion should occur and the extent of the discussion. PCAOB standards emphasize that communication among the team members about significant matters affecting the risks of material misstatement should continue throughout the audit.

Making Inquiries Related to Fraud

Inquiries of management and other personnel assist the auditors in identifying fraud risks. Therefore, the auditors are required to inquire of members of management as to their knowledge of fraud or alleged fraud, their understanding of the risks of fraud, and programs or controls that have been implemented to mitigate those risks. Inquiries will also include whether the company has entered into any **significant unusual transactions** and, if so, their nature, terms, and business purposes, including whether such transactions involved related parties. The auditors also inquire about how management monitors operating units or business segments in other locations and how management communicates its views about ethical behavior to employees. The auditors should obtain management's perspective regarding the effectiveness of internal control in detecting fraud and whether this perspective has been reported to the audit committee.

⁹ Mark Beasley, Joseph Carcello, Dana Hermanson, and Terry Neal, "Fraudulent Financial Reporting: 1998–2007—An Analysis of U.S. Public Companies" (Committee of Sponsoring Organizations of the Treadway Commission [COSO], 2010).



Illustrative Case

Fraud at WorldCom



At the time, WorldCom Inc. became the largest company to file for bankruptcy in corporate history. The bankruptcy was precipitated by the discovery of one of the largest accounting frauds, with profits

fraudulently inflated by more than \$11 billion. Company internal memos indicate that senior WorldCom executives overrode the system of internal control and ordered subordinates to alter the company's books.

Inquiries are directed to internal auditors and members of the audit committee to get their views about fraud risks and determine whether these individuals have knowledge of fraud (or suspected fraud) and any significant unusual transactions. To get a more complete perspective and corroborate management's responses, auditors also should make inquiries of other employees, such as operating personnel not directly involved in financial reporting; employees involved in initiating, recording, or processing complex or unusual transactions; and in-house legal counsel. These inquiries are important because fraud often is uncovered through information received in response to inquiries.

Performing Risk Assessment Analytical Procedures to Identify Fraud Risks

Risk assessment analytical procedures also may provide the auditors with indications of fraud risks. When the results of analytical procedures reveal an unusual or unexpected relationship, this may provide an indication that the financial statements may be misstated due to fraud. Because revenue manipulation is one of the most common techniques used in fraudulent financial reporting, the professional standards require the auditor to perform risk assessment analytical procedures related to revenue recognition. For example, the auditors might compare monthly revenue for the current year with comparable prior years for an indication that revenue may be misstated.

Considering Fraud Risk Factors

In identifying fraud risks, the auditors also consider various fraud risk factors. Fraud risk factors do not necessarily indicate the occurrence of fraud; however, they often are present where fraud exists. AICPA AU-C 240 and PCAOB AS 2401 provide lists of such factors organized around the three fundamental conditions outlined by the fraud risk triangle for the commission of fraud: (1) some type of incentive or pressure, (2) an opportunity to commit the fraud, and (3) an attitude that allows the individual to rationalize the act. As an illustration, an accounts receivable clerk who is having a personal financial difficulty may feel pressured to commit fraud, and a weakness in internal control may provide that individual with the opportunity to steal cash receipts. Finally, the employee may be able to rationalize the theft based on a belief that they are underpaid. Appendix 6B provides listings of fraud risk factors for misstatements arising from both fraudulent financial reporting and misappropriation of assets.

Identifying Fraud Risks

After holding the engagement team discussion, performing the inquiries and planning analytical procedures, and considering the presence of fraud risk factors and other information that might be relevant, the auditors are ready to identify fraud risks that may require an audit response. In identifying the risks that require an audit response, the auditors consider a number of factors, including the type and significance of the risk, the likelihood that the risk will result in a material misstatement, and its pervasiveness. Because material misstatements due to fraudulent financial reporting often involve management override of internal control, resulting in overstatement of revenue, auditors ordinarily should presume that there is a fraud risk related to revenue recognition. For all fraud risks identified by the auditors, they should obtain an understanding of the programs and controls enacted by management to mitigate the risks. This information about controls will assist the auditors in determining the significance of the risk and in designing an effective audit approach to address the risks.

FIGURE 6.4 Conditions Indicative of Fraud

Discrepancies in the Accounting Records	Conflicting or Missing Evidence	Problematic or Unusual Relationships between the Auditors and Client
• Transactions that are not recorded in a complete or timely manner or are improperly recorded as to amount, accounting period, classification, or accounting policy • Unsupported or unauthorized balances or transactions • Last-minute adjustments that significantly affect financial results • Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorized duties	• Missing documents • Unavailability of documents in original form when they are expected to exist • Significant unexplained items on reconciliations • Inconsistent, vague, or implausible responses from management or employees arising from inquiries or the results of analytical procedures • Unusual discrepancies between the entity's records and confirmation replies • Missing inventory or physical assets of significant magnitude • Unavailable or missing electronic evidence, inconsistent with the entity's record-retention practices or policies • Inability to produce evidence of key systems development and program-change testing and implementation activities for current-year system changes and deployments	• Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought • Undue time pressures imposed by management to resolve complex or contentious issues • Complaints by management about the conduct of the audit or management intimidation of audit team members, particularly in connection with the auditors' critical assessment of audit evidence or in the resolution of potential disagreements with management • Unusual delays by the entity in providing requested information • Tips or complaints to the auditors about fraud • Unwillingness to facilitate auditor access to key electronic files for testing through the use of computer-assisted audit techniques • Denial of access to key information technology operations staff and facilities including security, operations, and systems development personnel

Even if specific risks of material misstatement due to fraud are not identified by the auditors, there is always a possibility of management override of internal control. Therefore, the professional standards require the auditors to address this risk apart from whether they identify other fraud risks. Figure 6.4 provides conditions that may indicate fraud.

Responding to Fraud Risks



How do the auditors respond to fraud risks? They respond in the following three ways: (1) a modification in approach having an overall effect on how the audit is conducted; (2) an alteration in the nature, timing, and extent of the procedures performed; and (3) performance of procedures to further address the risk of management override of internal control.

Overall Response

In response to fraud risks, the auditors may modify their overall approach to the audit in one or more of the following ways:

- *Professional skepticism and audit evidence.* The auditors may design procedures to obtain more reliable evidence in support of specific financial statement items or by obtaining additional corroboration of management's explanations or representations concerning material matters, such as through third-party confirmation, the use of a specialist, or examination of documentation from independent sources.
- *Assigning personnel and supervision.* The auditors may assign additional staff with specialized skill and knowledge or assign more experienced staff to the engagement. In addition, the extent of the supervision of the audit staff should be adjusted to reflect the fraud risks identified.
- *Accounting principles.* The auditors may further consider management's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions.

- *Predictability of auditing procedures.* The auditors may incorporate an added element of unpredictability in the selection of auditing procedures. As examples, they may use differing sampling techniques, adjust the timing of testing from what otherwise would be expected, or perform procedures at locations on an unannounced basis.

Alterations in Audit Procedures

Alterations of the nature, timing, or extent of audit procedures to address a fraud risk may involve applying procedures that provide more reliable evidence, shifting tests from the interim period to near year-end, or increasing the sample size for a particular substantive procedure. As an example, the auditors might decide to interview personnel involved in activities in areas where a fraud risk has been identified to obtain their insights about the risk and how controls address that risk. Linking audit procedures to risks is described in more detail later in this chapter.

Response to the Possibility of Management Override

As indicated previously, on every audit, the auditors are required to design procedures to further address the risk of management override of controls. Specifically, these procedures include

- *Examining journal entries and other adjustments for evidence of material misstatement due to fraud.* Material misstatements of financial statements due to fraud often involve the manipulation of the financial reporting process by recording inappropriate journal entries or adjustments. In examining journal entries, the auditors should carefully consider factors such as who is able to (1) create, (2) approve, (3) record, and (4) review journal entries. The auditors begin by considering who is authorized to perform each of these functions, followed by a consideration of who is not authorized but may be able to do so by overriding internal control. For example, top management may not be authorized to record entries but may be able to override the system used to record journal entries. The auditors should review selected entries and adjustments for suspicious characteristics, such as entries made to unrelated, unusual, or seldom-used accounts; entries recorded at the end of the period or as post-closing entries that have little or no explanation or description; or entries made either before or during the preparation of the financial statements that do not have account numbers. As discussed in Chapter 5, auditors increasingly use data analytic approaches to efficiently examine entire sets of journal entries as contrasted to examination of a sample. As an example, if fraud risks relate to adjusting entries, the auditors may be able to efficiently query the entire population of adjustments for suspicious entries (e.g., illogical entries, incomplete explanations). Auditors may also use **artificial intelligence** software to identify accounting entries with high or moderate risk. This type of software actually uses **machine learning** to improve its detection abilities.
- *Reviewing accounting estimates for biases.* Fraudulent financial reporting often is accomplished through intentional misstatement of accounting estimates, such as the allowance for uncollectible accounts. Thus, auditors should perform a retrospective review of significant accounting estimates reflected in the financial statements of the prior year to determine whether management judgments and assumptions relating to the estimates indicate a possible bias on the part of management. For example, in performing a retrospective review of the allowance for uncollectible accounts, the auditors might compare management's estimate used in the prior financial statements with the amounts eventually determined to be uncollectible. Evidence of bias in the prior year should be considered in auditing the current-year accounting estimates.
- *Evaluating the business purpose of any significant unusual transactions.* During the course of the audit, if the auditors encounter significant unusual transactions, they should gain an understanding of their business purpose as it relates to the company. Also, as discussed in Chapter 5, the auditors should be especially alert for such transactions with related parties.

Evaluating the Results of Audit Tests

The auditors' concern about fraud does not stop at the planning phase of the audit. Throughout the engagement, the auditors should be alert for conditions that may indicate that a fraud was committed, such as those presented in Figure 6.4. In addition, analytical procedures performed during the course of the audit may reveal unusual or unexpected relationships that may indicate the occurrence of fraud. As an example, an unexpected relationship between sales volume as determined from the accounting records and sales volume determined from production statistics maintained by operations personnel may indicate a fraudulent misstatement of sales.

At or near completion of the audit, the auditors should evaluate whether the accumulated results of audit procedures and other observations affect the assessment of the risks of material misstatement due to fraud made earlier in the audit.

Discovery of Fraud

What do the auditors do if they obtain evidence of fraud? They should evaluate the implications for the audit and communicate their suspicions to an appropriate level of management, at least one level above the level involved. If the fraud involves senior management or material misstatement of the financial statements, the matter should be reported to the audit committee of the board of directors. In very serious situations, the auditors may decide to withdraw from the engagement.

Designing Further Audit Procedures in Response to Assessed Risks

LO 6-7

Discuss how the auditors design further audit procedures in response to the assessed risks of material misstatement.

The auditors' selection of **further audit procedures** emphasizes the audit of significant account balances, classes of transactions, and disclosures and their relevant assertions and assessed risks of material misstatement. These further audit procedures include substantive procedures for all relevant assertions and, if appropriate, tests of controls. Tests of controls are appropriate when the auditors' risk assessment includes an expectation that controls are operating effectively, or when substantive procedures alone do not provide sufficient appropriate audit evidence. Chapters 10 through 16 include detailed illustrations of tests of controls and substantive procedures. Here we simply provide an overview of factors that may affect the nature of further audit procedures.

Designing further audit procedures is a critical process that involves complex judgment to *link* specific audit procedures with the assessed risks at the relevant assertion level. When designing further audit procedures, auditors consider the *nature*, *timing*, and *extent* of appropriate procedures. As discussed in Chapter 5, the higher the risk, the more reliable and relevant is the *nature* of the audit evidence sought by the auditor. For example, to improve reliability, it may be possible to increase the use of externally generated evidence in a risky area. When considering the *timing* of audit procedures, auditors may perform tests of controls or substantive procedures at an interim date or at period end. The higher the risk of material misstatement, the more likely it is that the auditors may decide to perform audit procedures nearer to, or at, the period end. In addition, a high risk of material misstatement for a particular assertion may result in an increase in the *extent* of audit procedures performed. To respond to higher risk on an overall basis, auditors may incorporate additional elements of unpredictability in the selection of audit procedures (e.g., modify the timing and approach related to inventory observations and receivable confirmations).

What other responses are appropriate when assessed risks of material misstatement are high? First, all auditors on the engagement, but particularly those working in high-risk areas, should apply a heightened degree of skepticism. In staffing the high-risk audit, the firm should consider

- Assigning more experienced staff to the engagement;
- Assigning individuals with specialized skills to the engagement; or
- Increasing the extent of supervision for the engagement.

Thus, further audit procedures in response to high assessed levels of risk may lead both to changes in the nature, timing, and extent of audit procedures and to changes in the staffing and supervision of the engagement. As indicated, substantive audit procedures are

determined based on the auditors' assessment of the risks of material misstatement (inherent and control risks) of various assertions about account balances, transactions, and disclosures. It is important for the auditors to design substantive procedures that are clearly focused on and linked to the risks. As an example, assume that a software company sells expensive software systems and maintenance using standard contracts. Also assume that the auditors have identified as a significant risk a situation in which sales personnel, informally or through written side agreements, may be modifying the terms of contracts with customers, which may affect the amount of revenue that should be recognized. The auditors should design tests that are focused on determining whether such modifications of terms have been made, perhaps by using tailored confirmations from customers about the existence of such side agreements. In addition, to the extent considered necessary, staff with experience with this sort of transaction might be assigned to the audit, and supervision of staff in this area may be increased.¹⁰ Details of audit procedures for account balances, transactions, and disclosures are emphasized in Chapters 10 through 16.

Notice that the emphasis is on auditing significant account balances, classes of transactions, and disclosures—that is, those with one or more relevant assertions. There may be account balances, classes of transactions, and disclosures that are material but have not been determined to be significant because they do not contain a relevant assertion. For these, auditors reevaluate their risk assessment to evaluate whether their determination remains appropriate.¹¹ Also, even when considered appropriate, auditors might perform auditing procedures on such an account, class of transaction, or disclosure when the overall risk of material misstatement for the financial statements is high or as a means of introducing unpredictability to procedures performed.

Revising the Risk Assessment

The process of identifying and assessing the risks of material misstatement, including fraud risks, continues throughout the audit. We have described this process as iterative and dynamic. When audit evidence obtained during the audit contradicts the audit evidence on which the auditor based the original risk assessments, the assessment and planned audit procedures should be revised appropriately in response to the revised risk assessments. For example, a risk assessment may be based on an expectation that certain controls are operating effectively, but the auditors' tests of controls may provide audit evidence that they were not operating as effectively as expected. In such circumstances, a revision of the risk assessment may result in an increase in the scope of substantive procedures to obtain assurance that any material misstatements are identified.

Audit Documentation

To appropriately document their risk assessment, the auditors should document (1) the discussion of the audit team concerning the risk of material misstatements due to error or fraud, (2) the key elements of the understanding of the entity and its environment, (3) the assessment of the risk of material misstatement at both the financial statement level and the assertion level, and (4) the risks identified. After the procedures have been performed, the auditors should document

- The auditors' overall responses to address the assessed risk of misstatement at the financial statement level;
- The nature, timing, and extent of further audit procedures performed;
- The linkage of those procedures with the assessed risks at the assertion level;
- The results of the audit procedures;

¹⁰ Chapters 7 and 16 discuss auditor communication of significant findings relating to internal control and other matters to those charged with governance of the client's organization. As is discussed in further detail in Chapter 17, PCAOB auditing standards (and international auditing standards for public companies) require auditors to include discussion of certain of these matters in audit reports. Of the matters communicated to the audit committee, PCAOB audit reports include any **critical audit matter**.

¹¹ This requirement is informally referred to as a "stand-back" requirement. It is intended to drive an evaluation of the completeness of the identification of significant classes of transactions, account balances, and disclosures by the auditor.

- With regard to the use of audit evidence, the conclusions reached about the operating effectiveness of controls obtained in a prior audit (this is discussed in Chapter 7);
- Significant risks identified and related controls; and
- Those circumstances in which substantive procedures alone will not provide sufficient evidence.

With respect to the auditors' consideration of fraud, the requirements are similar in that auditors should document (1) the discussion among engagement team personnel about fraud risks; (2) the procedures performed to identify fraud risks; (3) the fraud risks identified and the response to those risks; (4) any other conditions that caused the auditors to perform additional fraud-related procedures; and (5) the nature of any communications made to management, the audit committee, or others about fraud.

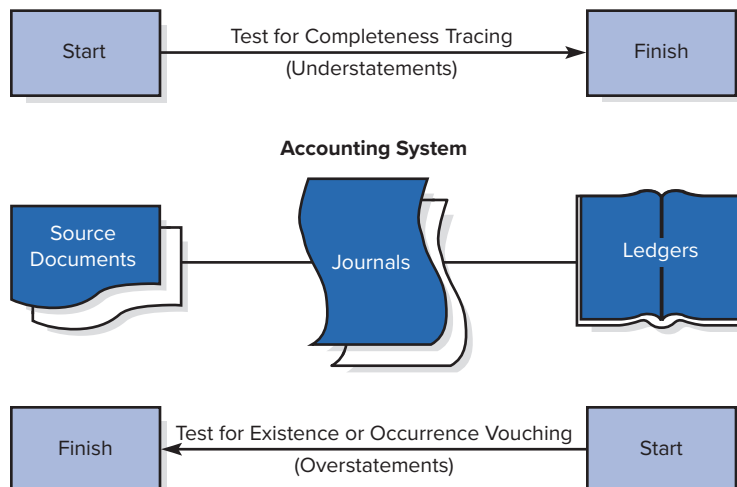
The Audit Trail and Directional Testing

In developing audit procedures, the auditors are assisted by the organized manner in which accounting systems record, classify, and summarize data. The flow of accounting data begins with the recording of thousands of individual transactions on such documents as invoices and checks. The information recorded on these original "source" documents is summarized in journals and the amounts in the journals are posted to ledger accounts. At the end of the year, the balances in the ledger accounts are arranged in the form of financial statements.

In thinking of the accounting records as a whole, we may say that a continuous trail of evidence exists—a trail of evidence that links the thousands of individual transactions composing a year's business activity with the summary figures in the financial statements. In a manual accounting system, this *audit trail* consists of source documents, journal entries, and ledger entries. An audit trail also exists within a computer-based accounting system, although it may have a substantially different form; this is discussed in Chapter 8.

Just as a hiker may walk in either direction along a mountain path, an auditor may follow the audit trail in either of two directions. Figure 6.5 illustrates these concepts relating to the *direction of testing*. For example, the auditor may trace specific transactions from their origin (the source documents) forward to their inclusion in the financial statement summary figures. This approach provides the auditor with assurance that all transactions have been properly recorded and reflected in the financial statements; it is a test of the *completeness assertion*. If a transaction was never recorded, the omission can be detected only by tracing in the direction from the source documents to the journals and ledgers. Note, however, that transactions that are not supported *can never* be found by tracing forward from source documents to the journal entries (left to right).

FIGURE 6.5
Direction of Tests





Illustrative Case

PCAOB Findings on Vouching Transactions



In its *Inspection Observations*, a document prepared in part to assist auditors by informing them of common audit deficiencies identified in inspections, the PCAOB reports that while auditors often vouched recorded balances to some underlying support, they frequently did it incompletely. For example, while auditors vouched recorded revenue

transactions to the company-prepared invoice, they did not test whether the invoice agreed to the terms of the contractual arrangement or obtain evidence that the products had been shipped (e.g., did not vouch to the shipping report). As such, appropriate conclusions may be very limited (e.g., recorded revenue transactions have a supporting sales invoice, rather than a conclusion on the appropriateness of the recording of the sale).

If the auditors' objective is to detect unsupported financial statement amounts, they should follow the stream of evidence back to its source. This type of test involves following amounts recorded in the financial statements for the period to ledgers and journals and, finally, *vouching* them to the original source documents, such as sales invoices and shipping reports. By vouching from right to left in Figure 6.5, the auditors may identify journal entries that are not supported and, possibly, not valid. This process of vouching, working backward from the financial statement figures to the detailed documents, provides evidence that financial statement figures are based upon valid transactions; it tests the *existence or occurrence assertion*.

Finally, although the technique of working along the audit trail is a useful one, bear in mind that the auditors also should acquire evidence from sources other than the client's accounting records.

Transaction Cycles (Classes of Transactions)

A **transaction cycle**, or class of transactions, is the sequence of procedures applied by the client in processing a particular type of recurring transaction. The term *cycle* conveys the idea that the same sequence of procedures is applied to each included transaction. Because of their importance to financial reporting, the auditors' consideration of internal control often is organized around the client's major transaction cycles. While they differ from company to company, typical cycles include (1) the revenue (sales and collections) cycle, (2) the acquisition (purchases and disbursements) cycle, (3) the conversion (production) cycle, (4) the payroll cycle, (5) the investing cycle, and (6) the financing cycle.

To illustrate a specific transaction cycle, consider a company's business processes for sales and collections of receivables. The activities performed to process sales transactions might include receiving a customer's purchase order, approving credit, shipping merchandise, preparing the sales invoice, recording the sale, recording the accounts receivable, billing the customer, and handling and recording the cash remitted by the customer. Ultimately, both a sales entry (recorded in the sales journal) and a cash receipts entry (recorded in the cash receipts journal) capture the essential information for financial reporting purposes. That information is then recorded in the appropriate ledger accounts (e.g., accounts receivable, sales, and cash). Figure 6.6 shows the Accounts Receivable general ledger account and how the sales and collections cycle affects that account. The figure also illustrates how sales returns and allowances and write-offs of uncollectible accounts affect the Accounts Receivable account.

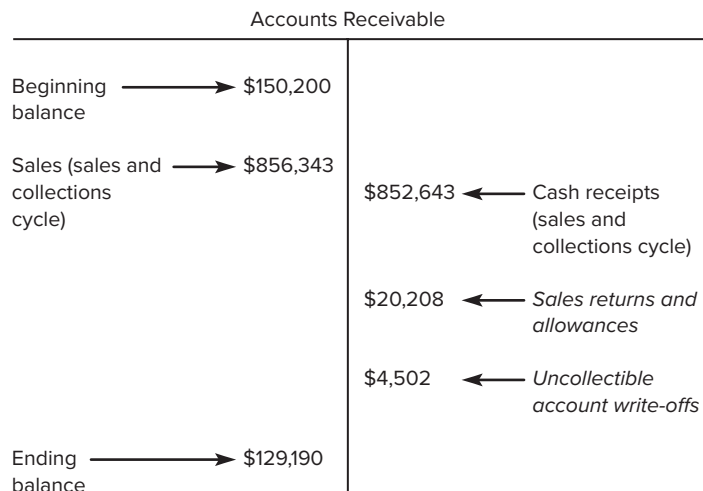
The Audit Plan's Systems and Substantive Portions

LO 6-8

Distinguish between the systems and the substantive procedures portions of the audit plan.

As discussed earlier in this chapter, the audit plan includes the audit's risk assessment procedures and planned further audit procedures. Two major portions of these procedures are procedures to obtain an understanding and assess the effectiveness of the client's internal control (the "systems portion") and procedures aimed directly at financial statement account balances (the "substantive portion").

FIGURE 6.6
Transactions Affecting
Accounts Receivable



The Systems (Internal Control) Portion of the Plan

As indicated above, the systems portion of the audit plan is generally organized around the major transaction cycles of the client's accounting system. Audit procedures in the systems portion of the plan typically include obtaining an understanding of the controls for each transaction cycle, preparing a flowchart for each cycle, testing the significant controls, and assessing control risk for the related financial statement assertions.

Figure 6.6 is helpful in illustrating the relationship between tests of controls over transactions and substantive procedures. Note that while the auditors' overall objective is to determine whether the ending financial statement balance is correct, two approaches are possible: (1) testing controls over transactions that occurred during the year or (2) testing the ending account balance directly. That is, if the controls over the transactions that are recorded into the account are effective, assurance is obtained regarding the ending balance. Alternatively, auditors may directly test the ending balance of the account. As a practical matter, auditors use a combination of these two approaches. Indeed, even if controls are considered extremely strong, some substantive procedures should be performed for all significant financial statement accounts.

The systems portion of the audit plan includes tests of controls over transactions. The evidence obtained from these tests may be of two types: evidence about the effectiveness of controls and evidence that substantiates the recorded amount of the transactions. For example, a test of a control may involve selecting a sample of sales transactions to test whether recorded transactions were properly approved. This procedure provides evidence to help assess control risk (or the combination of inherent risk and control risk). It does *not* provide evidence to restrict detection risk because no evidence substantiating the transactions and related balances has been collected (for example, a sale may be approved but may be recorded at an erroneous amount). However, if the auditors simply extend the test to include a determination of whether the transactions were properly recorded, evidence is collected to substantiate sales transactions and the accounts receivable balance. Such procedures are referred to as **dual-purpose procedures (tests)** because they serve as both a test of controls and a substantive test of the details of the transactions that occurred during the year. It should be emphasized, however, that the systems portion of the audit plan primarily addresses tests of internal control and assessing control risk.

As a result of their consideration of internal control, the auditors will make appropriate modifications in the substantive procedures portion of the audit plan. For example, because of weaknesses in internal control over the proper recording of sales, the auditors may assess control risk and the risk of material misstatement for the assertion of existence of accounts receivable as high and decide to send additional accounts receivable confirmations. Alternatively, strong controls may lead the auditors to decide to perform less extensive substantive procedures than would be the case if controls did not function effectively.

The Substantive Procedures Portion of the Plan

The portion of the audit plan aimed at substantiating financial statement amounts emphasizes significant financial statement accounts and classes of transactions, such as cash, accounts receivable, sales, inventories, and plant and equipment. Substantive procedures are used to restrict detection risk for these accounts. As an example, consider the financial statement account Accounts Receivable. Examples of audit procedures for accounts receivable include confirming with debtors their balance due, reviewing the year-end cutoff of sales transactions, and analyzing subsequent collections of year-end receivables. These procedures all help substantiate the year-end accounts receivable balance.

Most audit firms organize much of the substantive portion of their audit plans around the balance sheet accounts. Then, they complete any additional procedures needed to substantiate income statement accounts and information in financial statement notes. An advantage of this balance sheet approach is that highly reliable evidence generally is available to substantiate assets and liabilities. For example, the ending balance of accounts receivable as presented in Figure 6.7 is usually subject to direct verification by such procedures as inspection of externally created documentary evidence, confirmation, and review of subsequent cash collections. Other assets such as inventory may be physically examined. Liabilities can be verified by examination of externally created documents, confirmation, and inspection of canceled checks after the liability has been paid.

In contrast, consider the nature of revenues and expenses in double-entry accounting. The entry to record revenues or expenses has two parts: (1) the recognition of the revenue or expense and (2) the corresponding change in an asset or liability account. Revenues and expenses have no tangible form; they exist only as entries in the client's accounting records, representing changes in owners' equity. Consequently, the best evidence supporting the existence of revenues or expenses is often the verifiable change in the related asset or liability account. As a result, many income statement accounts may be verified indirectly by auditing the related balance sheet accounts.

Indirect Verification of Income Statement Accounts

Figure 6.7 shows the relationship between income statement accounts and the related changes in cash or other balance sheet items. By substantiating the changes in the asset and liability accounts, the auditors indirectly verify revenue, cost of goods sold, and expenses. As an example, most revenue transactions involve a debit to either Cash or Accounts Receivable. If the auditors are able to satisfy themselves that all cash receipts and all changes in accounts receivable during the year have been properly recorded, they have indirect evidence that revenue transactions have been accounted for properly.

Direct Verification of Income Statement Accounts

Not all of the audit evidence pertaining to income statement accounts is indirect. The verification of a major balance sheet item often involves several closely related income statement accounts that can be verified through computation or other direct evidence. For example, in substantiating the marketable securities owned by the client, it is a simple matter to compute the related interest revenue, dividends revenue, and gains or losses on sales of securities. In substantiating the balance sheet items of plant assets and accumulated depreciation, the auditors make computations that also substantiate depreciation expense. Uncollectible accounts expense is substantiated in conjunction with the balance sheet item Allowance for Doubtful Accounts. In addition to these computations, the auditors' *analytical procedures* provide direct evidence as to the reasonableness of various revenues and expenses.

Certain income statement accounts, such as revenues, are of such significance that the auditors virtually always obtain direct evidence about the fairness of the amounts, typically by performing tests of details of a sample of transactions or substantive analytical procedures.

FIGURE 6.7 The Auditors' Approach to Auditing Financial Statement Accounts

Income Statement Items		Cash Transactions		Balance Sheet Items			
Financial Statement Relationships	Revenue	=	Cash receipts from customers	–	Beginning balance of Accounts Receivable	+	Ending balance of Accounts Receivable
	Cost of goods sold	=	Cash payments for merchandise	–	Beginning balance of Accounts Payable	+	Ending balance of Accounts Payable
				+	Beginning balance of Inventory	–	Ending balance of Inventory
	Expenses	=	Cash payments for expenses	–	Beginning balance of Accrued Expenses	+	Ending balance of Accrued Expenses
Auditors' Approach to Substantiation				+	Beginning balance of Prepaid Expenses	–	Ending balance of Prepaid Expenses
				↑		↑	
	Verify indirectly by substantiating right-hand side of equation; also use analytical procedures, direct computations, and tests of transactions		Substantiate by testing transactions; also perform reconciliations of cash accounts		Substantiate by reference to last year's audit working papers		Substantiate by substantive tests in current year

Summary of the Relationship between Tests of Controls and Substantive Procedures

Tests of controls provide auditors with evidence as to whether prescribed controls are in use and operating effectively. The results of these tests assist the auditors in evaluating the *likelihood* that material misstatements have occurred. Substantive procedures, on the other hand, are designed to *detect* material misstatements if they exist in the financial statements. The amount of substantive testing done by the auditors is greatly influenced by their assessment of the likelihood that material misstatements exist.

To illustrate, assume that a client's procedures manual indicates that the finished goods warehouse is to be locked at all times and accessible only to authorized personnel. Through tests of controls consisting of inquiry and observation, the auditors learn that the warehouse often is unlocked and that several employees who are not authorized to be in the warehouse regularly eat lunch there. Because the client's internal control procedure is not operating properly, the auditors should recognize that the *risk* of inventory shortages is increased. However, the tests of controls have *not* determined that an inventory shortage does, in fact, exist.

The principal substantive procedure to detect shortages of inventories is the auditors' observation of a physical inventory taken by the client. As part of this observation, the auditors make test counts of various items. In the case of the unlocked warehouse, the auditors' test has shown that internal control cannot be relied upon to prevent shortages. Therefore, the auditors should increase the number of test counts in an effort to verify the existence of inventory.

Objectives of Audit Plans

The audit procedures contained in the audit plan are designed to be responsive to potential material misstatements of the financial statements. To make sure that the plan addresses all potential misstatements, auditors often develop audit objectives for each significant account balance and class of transactions. These objectives follow directly from management assertions that are contained in the client's financial statements. From these assertions, general objectives may be developed for each major type of balance sheet account, including assets, liabilities, and owners' equity, and the related income statement accounts. Figure 6.8 presents the relationships between financial statements, management's account balance assertions (discussed in Chapter 5), and audit objectives.

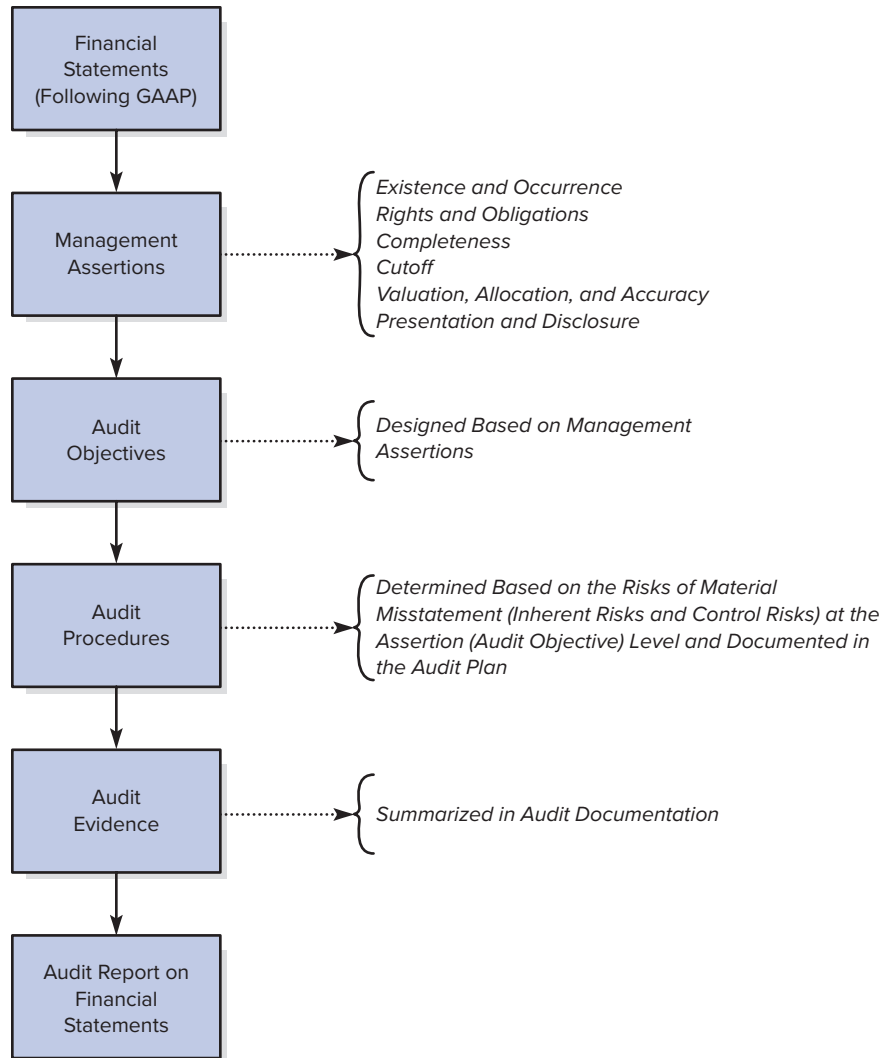
General Objectives of Audit Plans for Assets

The audit plan for each financial statement account should be tailored to address potential misstatements of that account. The potential misstatements for cash are not identical to the potential misstatements for accounts receivable. For example, questions about proper net realizable value cause valuation to be a bigger risk for accounts receivable. However, it is useful to realize that each audit plan follows basically the same general approach to verify the balance sheet items and related income statement amounts. To varying degrees based on the auditors' assessments of risk, the substantive audit plan for each asset account will need to include procedures to address the following general objectives:

Substantive Audit Plan for Asset Accounts Stated in Terms of General Objectives

- A. Establish the *existence* of assets.
- B. Establish that the company has *rights* to the assets.
- C. Establish *completeness* of recorded assets.
- D. Verify the *cutoff* of transactions.
- E. Determine the appropriate *valuation* of the assets.
- F. Determine the appropriate financial statement *presentation and disclosure* of the assets.

FIGURE 6.8
Relationship of Financial
Statement Assertions to
the Audit



Changes in these audit objectives, with respect to audit plans for liability and owners' equity accounts, will be discussed in later chapters.

Substantiation of Account Balances

The central purpose of the auditors' risk assessment process, including their assessment of control risk, is to determine the nature, timing, and extent of the audit work necessary to substantiate the account. In subsequent chapters, considerable attention will be given to the auditors' inherent and control risk assessments; let us now discuss the objectives of the auditors' substantive procedures.

Existence of Assets

The first step in substantiating an asset is to verify the existence of the item. For assets such as cash on hand, marketable securities, and inventories, existence of the asset usually may be verified by physical observation or inspection, and by *vouching* from the recorded entry to the source documents created when the assets were acquired.

When assets are in the custody of others, such as cash in banks and inventory on consignment, the appropriate audit procedure may be direct confirmation with the outside

party. The existence of accounts receivable normally is verified by confirming with customers the amounts receivable. To verify the existence of intangibles, the auditors should gather evidence that costs have been incurred and that these costs represent probable future economic benefits.

Rights to the Assets

Usually, the same procedures that verify existence also establish the company's rights to the asset. For example, confirming cash balances in bank accounts establishes existence of the cash and the company's ownership rights to that cash. Similarly, inspecting marketable securities verifies both existence and ownership because the registered owner's name usually appears on the face of the security certificate.

With other assets, such as plant and equipment, physical examination establishes existence *but not ownership*. Plant and equipment may be rented or leased rather than owned. To verify the client's rights to plant assets, the auditors should inspect documentary evidence such as property tax bills, purchase documents, and deeds.

The client may not hold legal title to all assets that are appropriately included in the financial statements. Instead, the client may own *rights* to use the assets conveyed by contracts, such as leases. The ownership of these rights may be established by reviewing the underlying contracts.

Establishing Completeness

Effective internal control provides assurance that acquisitions are recorded and helps the auditors to establish the completeness of recorded assets. When such controls are found to be ineffective, the scope of substantive procedures should be increased, but this is often a difficult task. When the auditors are testing the completeness of assets, they are looking for assets that have been acquired but not recorded in the accounting records. Therefore, analyzing recorded entries in the asset accounts will not be effective for this purpose; the auditors should take a different approach.

Many tests for unrecorded assets involve *tracing* from the "source documents" created when the assets were acquired to entries in the accounting records. To test for unrecorded accounts receivable, for example, the auditors might select a sample of shipping documents for inspection related to sales made during the year and determine that associated accounts receivable were properly recorded.

Observation and physical examination are important to testing the completeness of recorded physical assets. To illustrate, during the observation of the client's physical inventory, the auditors are alert for inventory items that are not counted or included in the inventory summary. Physically examining equipment may reveal purchases that have not been properly capitalized.

Analytical procedures also may be used to bring conditions to light that indicate that all assets may not be recorded. For example, a low gross profit percentage for the current year in comparison to prior years may indicate that the client has a substantial amount of unrecorded inventory.

Verifying the Cutoff

As a part of the auditors' procedures for establishing completeness as well as existence of recorded assets, the auditors will verify the client's *cutoff* of transactions included in the period. The financial statements should reflect all transactions occurring through the end of the period and none that occur subsequently. The term *cutoff* refers to the process of determining that transactions occurring near the balance sheet date are assigned to the proper accounting period.

The impact of cutoff errors upon the financial statements varies with the nature of the error. For example, a cutoff error in recording acquisitions of plant assets affects the balance sheet but probably does not affect the income statement because depreciation usually is not recorded on assets acquired within a few days of year-end. On the other hand, a cutoff error in recording shipments of merchandise to customers affects both inventory

and the cost of sales. In order to improve their financial picture, some clients may “hold their records open” to include in the current year cash receipts and revenue from the first part of the next period.

To verify the client’s cutoff of transactions, the auditors should review transactions recorded shortly before and after the balance sheet date to ascertain that these transactions are assigned to the proper period. Because such documents as checks, receiving reports, and shipping documents are usually serially numbered, noting the last serial number issued during the period will assist the auditors in determining that a proper cutoff has been made in recording transactions.

Valuation of Assets

Determining the proper valuation of assets requires a thorough knowledge of generally accepted accounting principles. Auditors generally must consider both (1) the accuracy of the original recording of the asset and (2) the subsequent valuation of the asset. As discussed below, for many assets, the original recording is at cost and relatively straightforward. Subsequent valuation varies by specific GAAP requirements relating to measurement bases required, such as net realizable value for receivables, the lower of cost or market for inventory, cost less accumulated depreciation for equipment, and fair value for marketable securities.

Since the acquisition of assets is generally recorded at cost, a common audit procedure is to test accuracy of its recording by vouching the acquisition cost of assets to paid checks, purchase orders, vendor sales invoices, and other documentary evidence. It is the subsequent valuation that may pose more difficulties. For example, if the acquisition cost is subject to depreciation or amortization, the auditors should evaluate the reasonableness of the cost allocation program and verify the computation of the remaining unallocated cost. Increasingly, generally accepted accounting principles require determination of the fair value of assets and liabilities. Certain assets and liabilities must be valued at fair value, others are valued at the lower of cost or net realizable value, and for some fair value must be determined to evaluate whether an asset is impaired. Fair values are audited by comparison to prices on existing actual or similar markets, or by evaluation and testing of the valuation models used to develop the values.

Finally, the amount appearing as an asset on a financial statement is almost always the accumulation of many smaller items. For example, the amount of inventory on a financial statement might consist of the cost of thousands or, perhaps, hundreds of thousands of individual products. The auditors should test the clerical accuracy of the underlying records to determine that they accumulate to the total appearing in the general ledger and, therefore, the amount in the financial statements. The auditors often use their audit software to perform tests of clerical accuracy of the records.

Financial Statement Presentation and Disclosure

Even after all dollar amounts have been substantiated, the auditors should perform procedures to ensure that the financial statement presentation conforms to the requirements of authoritative accounting pronouncements and the general principle of adequate disclosure. Procedures falling into this category include the review of subsequent events; search for related party transactions; investigation of loss contingencies; review of disclosure of such items as accounting policies, leases, compensating balances, and pledged assets; and consideration of the classification and description of items in the financial statements.

An Illustration of Audit Plan Design

The preceding general objectives apply to all types of assets. Audit procedures for a particular asset account should be designed to address the *specific audit objectives and risks* related to that asset. These specific objectives and risks vary with the nature of the asset and the accounting principles that govern its valuation and presentation.

FIGURE 6.9 Relationships among Audit Objectives, Risks of Material Misstatement, and Audit Procedures

General Audit Objectives for Assets	Specific Audit Objectives for Accounts Receivable	Risks of Material Misstatement: “What Can Go Wrong”	Example Audit Procedures
Existence of assets	All recorded receivables exist.	Receivables may have been recorded that do not exist. Management may have fraudulently overstated revenue and receivables by making inappropriate adjusting journal entries.	Confirm a sample of receivables by direct communication with debtors. Inspect monthly adjusting entries for suspicious items.
Rights to assets	The client has rights to the receivables.	Accounting personnel may erroneously treat a sale of receivables as a liability.	Inspect confirmations of liabilities to determine if receivables have been sold or factored.
Completeness of assets	All receivables are recorded.	Management may have shipped items but not recorded the sales.	Select a sample of shipping documents and trace them to the sales invoices and recorded sales entries.
Cutoff of transactions	Sales transactions are recorded in the proper period.	Sales and receivables for the next period may be recorded in the current period.	Vouch sales journal entries shortly before year-end to the shipping documents.
Valuation of assets	Receivables are presented at net realizable value.	Allowance for uncollectible accounts may be misestimated by management. Allowance for sales returns and allowances may be misestimated by management. Software routine to develop aged trial balance of receivables may have been erroneously programmed.	Investigate the credit ratings for delinquent and large receivables. Compare the amount of credits given to customers in the subsequent period to the amount estimated by management. Obtain an aged trial balance of receivables, test its clerical accuracy, and reconcile to the ledgers.
Financial statement presentation of assets	Receivables are properly presented in the balance sheet, with appropriate disclosures.	Accounting personnel may have failed to identify related party transactions.	Provide a list of related parties to all members of the audit team to assist in identification of the transactions.

In designing an audit plan for a specific account, the auditors start by listing the specific objectives related to the account. Then, they identify the inherent risks related to each of these specific audit objectives. You can think of these risks as declarations of “what could go wrong and thereby result in a material misstatement of the account.” Figure 6.9 provides a description of the relationships among audit objectives, risks of material misstatement, and audit procedures.

Figure 6.9 includes examples of identified risks related to each audit objective and only one procedure to address each risk. Usually, a greater number of risks are related to

each objective and several procedures may have to be performed to address a particular risk. For example, the audit objective of determining that receivables are properly presented in the balance sheet is not achieved solely by performing procedures focusing on the risk of inadequate disclosure of related party transactions. The audit plan should include procedures that focus on other risks related to presentation and disclosure, such as procedures that focus on the risk that the financial statements fail to disclose that receivables have been pledged as collateral for debt. In addition, the complete audit plan will include tests of the client's internal control that provide support for the auditors' assessments of control risk.

Chapters 10 through 16 consider the manner in which auditors design tests of controls and substantive procedures for various financial statement accounts. Specific audit objectives and sample audit procedures are presented for various accounts to provide a framework for our discussion. It is important to remember that the audit plans presented in the textbook merely illustrate *typical* procedures. In actual practice, audit plans should be tailored to each client's risks and internal control. The audit procedures in audit plans may vary substantially from one engagement to the next.

Timing of Audit Work

The value of audited financial statements is enhanced if the statements are available on a timely basis after the year-end. To facilitate a timely release of the audit report, auditors normally begin the audit well before the balance sheet date. The period before the balance sheet date is termed the **interim period**. Audit work that can always be started during the interim period includes the consideration of internal control and substantive tests of transactions that have occurred to the interim date.

As discussed in Chapter 5, interim tests of certain financial statement balances, such as accounts receivable, also may be performed, but risk is presented by the transactions that occur in the remaining period. Thus, significant misstatements due to error or fraud could arise in these accounts during the period between the time that the interim test was performed and the balance sheet date. Thus, to rely on the interim test of a significant account balance, the auditors should perform additional tests of the account during the remaining period.

Performing audit work during the interim period has numerous advantages, in addition to facilitating the timely release of the audited financial statements. The independent auditors may be able to assess internal control more effectively by observing and testing controls at various times throughout the year. Also, they can give early consideration to accounting problems. Another advantage is that interim auditing creates a more uniform workload for CPA firms. With a large client, such as General Motors, the auditors may have office space within the client's buildings and perform audit procedures throughout the entire year.

Chapter Summary

This chapter explained the manner in which auditors plan an audit, obtain an understanding of the client, assess risks of misstatements, and respond to those risks. To summarize:

1. The audit process may be viewed as including the following six stages: (a) plan the audit; (b) obtain an understanding of the client and its environment, including internal control; (c) assess the risks of misstatement and design further audit procedures; (d) perform further audit procedures; (e) complete the audit; and (f) form an opinion and issue the audit report.
2. Investigating a potential audit client is essential because auditors want to avoid accepting clients that have unscrupulous management. As part of their investigation, the auditors are required to attempt communication with the predecessor auditors.
3. In planning the audit, the auditors establish an understanding with the client, ordinarily in writing through use of an engagement letter that makes clear the nature of

the engagement, any limitations on the work, and the responsibilities of the client. During planning, auditors develop an overall audit strategy, which includes an audit plan. The audit procedures that are contained in the audit plan are designed around the assertions of management, which are embodied in the financial statements and the auditors' assessments of risks and controls.

4. Auditors obtain an understanding of the client and its environment to help plan the audit and to assess the risks of material misstatement at the financial statement and assertion levels. In considering the materiality of a possible misstatement, during planning the emphasis is upon quantitative considerations, while in evaluation both quantitative and qualitative considerations are emphasized. The concept of tolerable misstatement applies materiality to a particular audit procedure.
5. When auditors assess the risks of material misstatement in the financial statements, they recognize that such risks exist at the financial statement level and at the assertion level. At the financial statement level, they evaluate possible effects on the overall financial statements and on financial statement assertions. At the assertion level, they assess inherent risk to identify significant accounts, transaction types, and disclosures. Those accounts, transaction types, and disclosures each have one or more relevant assertions, that is, assertions with a reasonable possibility of containing material misstatement without considering the effect of controls. When the combination of the likelihood of misstatement and the magnitude of misstatement is very high, the risk should be considered a significant risk that requires special audit consideration.
6. The auditors should apply the materiality concept, which recognizes that some matters are important to the fair presentation of financial statements, while others are not. Auditors arrive at a measure of materiality for planning purposes and disaggregate it into tolerable misstatements for the various audit procedures. In evaluating findings, auditors also use materiality. While the materiality measures for both planning and evaluation include quantitative and qualitative considerations, the planning measure emphasizes quantitative considerations, while the evaluation measure emphasizes both quantitative and qualitative considerations.
7. Auditors assess the risks of misstatement they have identified to design further audit procedures. Further audit procedures include both tests of controls and substantive procedures.
8. The overall audit plan includes the audit's risk assessment procedures and planned further audit procedures (tests of controls and substantive procedures). Two major portions of these procedures are those to obtain an understanding and assess the effectiveness of the client's internal control (the "systems portion") and those aimed directly at financial statement account balances (the "substantive portion").

Key Terms Introduced or Emphasized in Chapter 6

Analytical procedures (236) Tests that involve comparisons of financial data for the current year to those of prior years, budgets, nonfinancial data, or industry averages. From a planning standpoint, analytical procedures help the auditors obtain an understanding of the client's business, identify financial statement amounts that appear to be affected by errors or fraud, or identify other potential problems.

Artificial Intelligence (AI) (249) The theory and development of computer systems able to perform tasks that normally require human intelligence. General examples of such tasks include visual perception, speech recognition, decision making, and translation between languages. In an auditing context, electronically performing various analyses historically performed by humans is hoped to increase both the efficiency and quality of audits.

Assertions (221) Representations of management, explicit or otherwise, that are embodied in the financial statements as used by auditors to consider the different types of potential misstatements that may occur.

Audit committee (224) A subcommittee of a company's board of directors that is charged with oversight of the financial reporting process, the audit process, the company's system of internal controls,

and compliance with laws and regulations. Within this role is responsibility for appointing, compensating, and overseeing the external auditors. Audit committee members are board of directors outside directors (members of the board of directors who are neither officers nor employees of the company).

Audit data analytics (ADAs) (227) The analysis of patterns, identification of anomalies, or extraction of other useful information in data underlying or related to the subject matter of an audit through analysis, modeling, or visualization.

Audit plan (230) A written or electronic document(s) that includes the nature, timing, and extent of audit procedures to be performed by the audit team members in order to obtain sufficient audit evidence. It includes planned risk assessment procedures, planned further audit procedures, and other necessary audit procedures.

Audit program (230) The audit plan. Although the professional standards use the term *audit plan*, many use the term *audit program*.

Audit risk (241) The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.

Business processes (234) The activity or activities designed to achieve specific objectives of an organization.

Business risks (221) Risks that threaten management's ability to achieve the organization's objectives. Such risks include inadequate profits or losses due to uncertainties, consumer changes in tastes, employee strikes, increased competition, change in government policy, obsolescence, etc.

Control risk (221) The risk that a material misstatement could occur in a financial statement assertion and not be prevented, or detected and corrected, on a timely basis by internal control.

Critical audit matter (251) Matters that were communicated or required to be communicated to the audit committee and that (1) relate to accounts or disclosures that are material to the financial statements, and (2) involved especially challenging, subjective, or complex auditor judgment. Critical audit matters are communicated for the audits of public companies.

Dual-purpose procedure (test) (254) An audit procedure that serves as a test of controls and a substantive test of the details of the transactions that occurred during the period. For example, a test of controls over equipment acquisitions may address authorization (providing evidence on control effectiveness) and whether the transaction tested has been properly recorded in the year's acquisitions (providing substantive evidence on the dollar amounts). As another example, a substantive procedure may reveal a misstatement and be extended to determine the nature of the control that did not operate effectively, thereby providing evidence on operating effectiveness.

Engagement letter (227) An agreement between the CPA firm and the client as to the terms of the audit engagement. The terms of the engagement should include (1) the objectives and scope of the audit, (2) auditor and management responsibilities, (3) inherent limitations of the audit, (4) the applicable financial reporting framework, and (5) the expected form and content of reports to be issued by the auditors.

Engagement risk (224) The risk of loss or injury to the auditors' reputation by association with a client that goes bankrupt or one whose management lacks integrity.

Fraudulent financial reporting (management fraud) (246) Material misstatement of financial statements by management with the intent to mislead financial statement users.

Further audit procedures (250) The additional procedures that are performed based on the results of the auditors' risk assessment procedures. Further audit procedures include tests of controls and substantive procedures, including (1) tests of details of account balances, transactions, and disclosures and (2) substantive analytical procedures.

Inherent risk (221) The risk of a material misstatement of a financial statement assertion before considering any related controls. Inherent risk may increase due to qualitative and quantitative inherent risk factors.

Inherent risk factors (243) Characteristics of events or conditions that affect the susceptibility to misstatement of an assertion about a class of transactions, account balance, or disclosure, whether due to error or fraud. Such factors may be qualitative or quantitative and include complexity, subjectivity, change, uncertainty, or susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk.

Interim period (262) The time interval from the beginning of audit work to the balance sheet date. Many audit procedures can be performed during the interim period to facilitate early issuance of the audit report.

Internet (233) An international network of independently owned computers that operates as a giant computing network. Data on the Internet are stored on “web servers,” which are computers scattered throughout the world.

Machine learning (249) An application of artificial intelligence (AI) that provides systems the ability to automatically learn and improve from experience without being explicitly programmed. Machine learning focuses on the development of computer programs that can access data and use it to learn for themselves.

Materiality (237) An amount (or disclosure) that would influence decisions that users make on the basis of the financial information of a specific reporting entity. More specifically, from the auditor’s perspective, it may be viewed as the amount at which the auditor believes that there is a substantial likelihood that, individually or in the aggregate, misstatements would influence the judgment of a reasonable user of the financial statements.

Misappropriation of assets (defalcations) (246) Theft of client assets by an employee or officer of the organization.

Opening balances (232) Those account balances that exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

Overall audit strategy (230) This strategy involves determining overall characteristics of the engagement that define its scope, determining the engagement’s reporting objectives to plan the timing of procedures, and considering important factors that will determine the focus of the audit team’s efforts. When the overall audit strategy has been established, the auditors start the development of a more detailed audit plan to address the various matters identified in the audit strategy.

Performance materiality (239) The amount (or amounts) set by the auditors at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the total of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. It also refers to the amount (or amounts) set by the auditor at less than the materiality level for particular classes of transactions, balances, or disclosures.

Predecessor auditors (226) A CPA firm that formerly served as auditor but has resigned from the engagement or has been notified that its services have been terminated.

Reasonable possibility (238) In the context of the risk of material misstatement, when the likelihood of a material misstatement occurring is more than remote.

Relevant assertion (240) An assertion about a class of transactions, account balance, or disclosure that has a reasonable possibility (its “likelihood”) of being materially misstated (its “magnitude”). The determination of whether an assertion is a relevant assertion is made before considering any related controls (that is, the determination is based on inherent risk).

Risk assessment procedures (221) The audit procedures performed to obtain an understanding of the entity and its environment, including the entity’s internal control. These procedures are designed to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels. Risk assessment procedures include (a) inquiries of management and others within the entity; (b) analytical procedures; and (c) observation and other procedures, including inquiries of others outside the entity.

Shopping for accounting principles (226) Conduct by some enterprises that discharge one independent auditing firm after seeking out another firm that will sanction a disputed accounting principle or financial statement presentation.

Significant risk (244) An identified risk of material misstatement that, in the auditors’ judgment, requires special audit consideration due to their assessment of its inherent risk. The auditors consider the likelihood of misstatement occurring and the magnitude of the potential misstatement both as high. Using the terminology of the AICPA, it is “close to the upper end of the spectrum of inherent risk.” Also, professional standards define specific circumstances that constitute significant risks related to revenue recognition and certain related party transactions (AU-C 240 and 550 and PCAOB AS 2110).

Significant unusual transactions (246) Significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual due to their timing, size, or nature.

Spectrum of inherent risk (243) A term used in the AICPA and IAASB standards referring to the degree to which the level of inherent risk may vary when both its likelihood and its magnitude are considered. The spectrum provides a frame of reference for various degrees of inherent risk considering likelihood and magnitude of a possible misstatement.

Substantive procedures (221) Tests of account balances and transactions designed to detect any material misstatements in the financial statements. Substantive procedures include (1) tests of details of transactions, account balances, and disclosures and (2) substantive analytical procedures. The nature, timing, and extent of substantive procedures are determined by the auditors' assessment of risks and their consideration of the client's internal control.

Successor auditors (226) The auditors who have accepted an engagement or who have been invited to make a proposal for an engagement to replace the CPA firm that formerly served as auditor.

Tests of controls (221) Tests directed toward the design or operation of a control to assess its effectiveness in preventing or detecting material misstatements of financial statement assertions.

Time budget (231) An estimate of the time required to perform each step in the audit.

Tolerable misstatement (240) The application of performance materiality to a particular sampling procedure. Tolerable misstatement is a monetary amount set by the auditors for a particular test to obtain an appropriate level of assurance from all the tests that the account is not materially misstated. Whereas the auditor may establish a level of performance materiality for an account (e.g., accounts receivable), the same or different tolerable misstatement levels may be established for each audit test performed for that account.

Transaction cycle (253) The sequence of procedures applied by the client in processing a particular type of recurring transaction. The term *cycle* reflects the idea that the same sequence of procedures is applied to each similar transaction. The auditors' consideration of internal control often is organized around the client's major transaction cycles.

Review Questions

- 6-1. What information should a CPA firm seek in its investigation of a prospective client?
- 6-2. In a public company, what requirements must members of the board of directors satisfy in order to serve on the audit committee?
- 6-3. State the purpose and nature of an engagement letter.
- 6-4. Discuss what is meant by the phrase "shopping for accounting principles." What mechanisms have served to prevent this practice by management?
- 6-5. Criticize the following statement: "Throughout this audit, for all purposes, we will define a 'material amount' as \$500,000."
- 6-6. Describe the two types of misstatements due to fraud. Which one generally is of more concern to the auditors?
- 6-7. Many CPA firms are taking a business risk approach to audits. Define what is meant by business risk. Provide an example of a business risk that could result in a risk of material misstatement of the financial statements.
- 6-8. Can a standard audit plan be used for most engagements?
- 6-9. "An audit plan is desirable when new staff members are assigned to an engagement, but an experienced auditor should be able to conduct an audit without reference to it." Do you agree? Discuss.
- 6-10. Describe the risk of material misstatement of an assertion. List the two components that make up this risk.
- 6-11. Certain audit risks are significant in that they require special audit consideration. Describe the typical characteristics of these significant risks.
- 6-12. Suggest some factors that might cause an audit engagement to exceed the original time estimate. Would the extra time be charged to the client?
- 6-13. What problems are created for a CPA firm when audit staff members underreport the amount of time spent in performing specific audit procedures?
- 6-14. Why is audit work usually organized around balance sheet accounts rather than income statement accounts?
- 6-15. Identify the general objectives of the auditors' substantive procedures with respect to any major asset category.

- 6-16. What is meant by making a proper year-end *cutoff*? Explain the effects of errors in the cutoff of sales transactions in both the income statement and the balance sheet.
- 6-17. What are the purposes of the audit procedures of (a) tracing a sample of journal entries forward to the ledgers and (b) vouching a sample of ledger entries back to the journals?
- 6-18. Charles Halstead, CPA, has a number of clients who desire audits at the end of the calendar year. In an effort to spread his workload more uniformly throughout the year, he is preparing a list of audit procedures that could be performed satisfactorily before the year-end balance sheet date. What audit work, if any, might be done in advance of the balance sheet date?
- 6-19. What is meant by the term “remote auditing”? How can remote auditing improve the efficiency of an audit?
- 6-20. The overall audit strategy, the audit plan, and the time budget are three important working papers prepared early in an audit. What functions do these working papers serve in the auditors’ compliance with auditing standards? Discuss.
- 6-21. Auditing standards require the auditors to have a team meeting regarding the risk of fraud for the engagement. What is the purpose of this meeting?
- 6-22. Many CPA firms are increasingly using remote auditing to facilitate audit engagements. What are the advantages of remote auditing? What are potential issues with using remote auditing?
- 6-23. When planning an audit, the auditors should assess the levels of risk and materiality for the engagement. Explain how the auditors’ judgments about these two factors affect the auditors’ planned audit procedures.
- 6-24. Comment on the following: Auditors recognize that while virtually all audits involve relevant assertions, extremely few audits include significant risks.

Questions Requiring Analysis

LO 6-2

LO 6-2, 3

- 6-25. Morgan, CPA, is approached by a prospective audit client who wants to engage Morgan to perform an audit for the current year. In prior years, this prospective client was audited by another CPA. Identify the specific procedures that Morgan should follow in deciding whether to accept this client.
- 6-26. Mary Deming has been asked to accept an engagement to audit a small financial institution. Deming has not previously audited a financial institution.
 - a. Describe the types of knowledge about the prospective client and its environment that Deming should obtain to plan the engagement, including sources of the information.
 - b. Explain how Deming may obtain this knowledge.
 - c. Discuss how this knowledge of the client and its environment will help Deming in planning and performing an audit in accordance with auditing standards.

LO 6-1, 3, 4, 7

- 6-27. Assume that you have been assigned to the audit of Lockyer Manufacturing Company. You have completed the procedures for gathering information about the company and its environment, including internal control.
 - a. Describe the next stage of the audit process.
 - b. Explain how the auditors may respond to high-risk audit engagements and high-risk audit assertions.
 - c. Describe the nature of *further audit procedures*, including when the procedures should include tests of controls.

LO 6-3

- 6-28. A CPA has been asked to audit the financial statements of a nonpublic company for the first time. All preliminary discussions have been completed between the CPA, the company, the predecessor auditors, and all other necessary parties. The CPA is now preparing an engagement letter. List the items that should be included in the engagement letter.

LO 6-6

- 6-29. Auditors should plan and perform their audits to provide reasonable assurance of detecting material misstatements in financial statements, including those resulting from fraud.
 - a. Distinguish between fraudulent financial reporting and misappropriation of assets.
 - b. Describe the three fundamental conditions necessary for the commission of fraud. Provide an illustration of these three conditions for a case of fraudulent financial reporting.
 - c. Describe the three ways in which the auditors may respond to fraud risks in an audit.

- LO 6-5** 6–30. In planning every audit, the auditors are required to consider materiality for audit purposes. Described below are financial statement data from two separate companies:

	Franklin Co.	Tyler Co.
Total assets	\$34,900,000	\$2,700,000
Total revenue	29,600,000	4,500,000
Equity	13,800,000	1,000,000
Net income before taxes	1,600,000	90,000

- a. Develop an estimate of the appropriate materiality amount for planning the Franklin Co. audit and describe how you arrived at the estimate.
 - b. Develop an estimate of the appropriate materiality amount for planning the Tyler Co. audit and describe how you arrived at the estimate.
 - c. Describe five characteristics of a small misstatement that might render it qualitatively material.
- LO 6-5** 6–31. The auditors sometimes decide to allocate the amount of materiality for planning to various financial statement accounts.
- a. Explain why auditors typically decide to allocate materiality for planning to individual financial statement accounts.
 - b. Describe why the total amount of materiality for planning allocated to individual accounts may exceed overall materiality.
- LO 6-6** 6–32. John Wells, CPA, is planning the audit of CVG Services Inc. As a result of his risk assessment procedures, Wells has identified several fraud risks.
- a. Explain in detail how Wells might respond to risks of material misstatement of the financial statements due to fraud.
 - b. Describe the auditors' communication responsibilities in situations in which the auditors believe fraud has occurred.
- LO 6-3, 4** 6–33. Listed below are several of the auditors' general objectives in performing substantive procedures on an asset account:
1. Establish the existence of assets.
 2. Establish that the company has rights to the assets.
 3. Establish the completeness of recorded assets.
 4. Verify the cutoff of transactions.
 5. Determine the appropriate valuation of the assets.
 6. Establish the clerical accuracy of the underlying records.
 7. Determine the appropriate financial statement presentation and disclosure of the assets.
- Indicate the general objective (or objectives) of each of the following audit procedures:
- a. Observe the client's physical inventory.
 - b. Locate on the client's premises a sample of the equipment items listed in the subsidiary plant and equipment ledger.
 - c. Obtain a listing of inventory and reconcile the total to the general ledger.
 - d. Trace a sample of shipping documents to recorded sales transactions.
 - e. Identify related parties.
 - f. Vouch selected purchases of securities to brokers' advices.
- LO 6-4, 5** 6–34. Auditors assess the risks of material misstatement and then design further audit procedures.
- a. Describe the auditors' approach to identifying and assessing the risks of material misstatement.
 - b. Describe likely responses when an audit is considered to be particularly high risk in terms of material misstatements, including complex transactions.
- LO 6-4, 5** 6–35. Auditors identify "significant risks" when performing their audits.
- a. Explain what is meant by a significant risk.
 - b. What factors do auditors consider in assessing whether a risk is a significant risk?
 - c. Describe how a significant risk should be treated in an audit.

- LO 6-7** 6–36. Richard Foster, an assistant auditor, was assigned to the year-end audit work of Sipher Corporation. Sipher is a small manufacturer of language translation equipment. As his first assignment, Foster was instructed to test the cutoff of year-end sales transactions. Because Sipher uses a calendar year-end for its financial statements, Foster began by obtaining the computer-generated sales ledgers and journals for December and January. He then traced ledger postings for a few days before and after December 31 to the sales journals, noting the dates of the journal entries. Foster noted no journal entries that were posted to the ledger in the wrong accounting period. Thus, he concluded that the client's cutoff of sales transactions was effective. Comment on the validity of Foster's conclusion. Explain fully.
- LO 6-6** 6–37. In every audit engagement, the auditors should identify fraud risks that may require an audit response. Described below are four circumstances or factors that may create an increased risk of material misstatement of the financial statements due to fraud.
1. The compensation of management of a subsidiary of the client is heavily dependent on the net income of the subsidiary and controls over subsidiary management are weak.
 2. The compensation of management of a telecommunications firm is significantly tied to revenue, and analytical procedures indicate that revenue may be overstated. The company engages in complex sales agreements.
 3. Futures traders in an energy company are compensated based on the performance of their purchases and sales of energy futures contracts. The markets for these contracts have few participants, resulting in the need to value contracts on hand at year-end based on complex valuation models applied by the traders.
 4. A chain of discount markets has inconsistent profit margins across stores as indicated by analytical procedures.
 - a. For each of the four circumstances, indicate the fraud risk that the auditors should consider.
 - b. For each of the four circumstances, indicate a possible appropriate response by the auditors.

Objective Questions

Select questions are available with Connect



LO 6-6

6–38. Multiple Choice Questions

Select the best answer for each of the following. Explain the reasons for your selection.

LO 6-2

- a. In planning and performing an audit, auditors are concerned about risk factors for two distinct types of fraud: fraudulent financial reporting and misappropriation of assets. Which of the following is a risk factor for misappropriation of assets?
 - (1) Generous performance-based compensation systems.
 - (2) Management preoccupation with increased financial performance.
 - (3) An unreliable accounting system.
 - (4) Strained relationships between management and competing companies.
- b. The audit committee of a company must be made up of:
 - (1) Representatives from the client's management, investors, suppliers, and customers.
 - (2) The audit partner, the chief financial officer, the legal counsel, and at least one outsider.
 - (3) Representatives of the major equity interests, such as preferred and common stockholders.
 - (4) Members of the board of directors who are not officers or employees.
- c. Which of the following should not normally be included in the engagement letter for an audit?
 - (1) A description of the responsibilities of client personnel to provide assistance.
 - (2) An indication of the amount of the audit fee.
 - (3) A description of the limitations of an audit.
 - (4) A listing of the client's branch offices selected for testing.

LO 6-2, 3

LO 6-7

- d. Which portion of an audit is least likely to be completed before the balance sheet date?
- (1) Tests of controls.
 - (2) Issuance of an engagement letter.
 - (3) Substantive procedures.
 - (4) Assessment of control risk.

LO 6-2

- e. Which of the following should the auditors obtain from the predecessor auditors before accepting an audit engagement?
- (1) Analysis of balance sheet accounts.
 - (2) Analysis of income statement accounts.
 - (3) All matters of continuing accounting significance.
 - (4) Facts that might bear on the integrity of management.

LO 6-4

- f. As one step in testing sales transactions, a CPA traces a random sample of sales journal entries to debits in the accounts receivable subsidiary ledger. This test provides evidence as to whether:
- (1) Each recorded sale represents a bonafide transaction.
 - (2) All sales have been recorded in the sales journal.
 - (3) All debit entries in the accounts receivable subsidiary ledger are properly supported by sales journal entries.
 - (4) Recorded sales have been properly posted to customer accounts.

LO 6-1, 7

- g. The primary objective of tests of details of transactions performed as substantive procedures is to:
- (1) Comply with auditing standards.
 - (2) Attain assurance about the reliability of the accounting system.
 - (3) Detect material misstatements in the financial statements.
 - (4) Evaluate whether management's policies and procedures are operating effectively.

LO 6-5

- h. The risk that the auditors will conclude, based on substantive procedures, that a material misstatement does not exist in an account balance when, in fact, such misstatement *does* exist is referred to as
- (1) Business risk.
 - (2) Engagement risk.
 - (3) Control risk.
 - (4) Detection risk.

LO 6-5

- i. An account with one or more relevant assertions is referred to as a
- (1) Detection risk account.
 - (2) Further account.
 - (3) Relevant account.
 - (4) Significant account.

LO 6-6

- j. Which of the following best describes what is meant by the term "fraud risk factor"?
- 1 Factors that, when present, indicate that risk exists.
 - 2 Factors often observed in circumstances where frauds have occurred.
 - 3 Factors that, when present, require modification of planned audit procedures.
 - 4 Weaknesses in internal control identified during an audit.

LO 6-6

- k. Three conditions generally are present when fraud occurs. Select the one below that is *not* one of those conditions.
- (1) Incentive or pressure.
 - (2) Opportunity.
 - (3) Supervisory position.
 - (4) Attitude.

LO 6-6, 7

l. Which of the following is most likely to be an overall response to fraud risks identified in an audit?

- (1) Supervise members of the audit team less closely and rely more upon judgment.
- (2) Use less predictable audit procedures.
- (3) Use only certified public accountants on the engagement.
- (4) Place increased emphasis on the audit of objective transactions rather than subjective transactions.

(AICPA, adapted)

LO 6-3, 4, 6

6–39.

Simulation

Michael Green, CPA, is considering audit risk at the financial statement level in planning the audit of National Federal Bank (NFB) Company's financial statements for the year ended December 31, 20X1. Audit risk at the financial statement level is influenced by the risks of material misstatements (including fraud risks), which may be indicated by a combination of factors related to management, the environment, and the entity. For each of the following factors, indicate (1) whether it increases or decreases the risk of material misstatement and (2) whether it creates a risk of fraud.

Factor	Effect on Risks of Material Misstatement (Increase or Decrease)	Creates a Risk of Fraud? (Yes or No)
a. NFB is a continuing audit client.		
b. The banking industry has been significantly impacted by the downturn in the economy in recent years.		
c. NFB operates in a growing, prosperous area and has remained profitable over the years.		
d. Government regulation and oversight of the banking industry is extensive and effective.		
e. NFB's board of directors is controlled by Smith, the majority stockholder, who also acts as the chief executive officer.		
f. Interest rates have been very volatile recently.		
g. Management at the bank's branch offices has authority for directing and controlling NFB's operations and is compensated based on branch profitability.		
h. The internal auditor reports directly to Harris, a minority shareholder, who also acts as chairman of the board's audit committee.		
i. The accounting department has experienced little turnover in personnel during the five years Green has audited NFB.		
j. During 20X1, NFB increased the efficiency of its accounting operations by installing a new, sophisticated computer system.		
k. NFB's formula has consistently underestimated the allowance for loan losses in current years.		
l. Management has been receptive to Green's suggestions relating to accounting adjustments.		

LO 6-4, 5

6–40.

Simulation

You are working with William Bond, CPA, and you are considering the risk of material misstatement in planning the audit of Toxic Waste Disposal (TWD) Company's financial statements for the year ended December 31, 20X0. TWD is a privately owned entity that contracts with municipal governments to remove environmental waste.

Based only on the information below, indicate whether each of the following factors would most likely increase (I), decrease (D), or have no effect (NE) on the risk of material misstatement.

Information	Effect on Risk of Material Misstatement
a. Because municipalities have received increased federal and state funding for environmental purposes, TWD returned to profitability for the first year following three years with losses.	
b. TWD's Board of Directors is controlled by Janice Mead, the majority stockholder, who also acts as the chief executive officer.	
c. The internal auditor reports to the controller and the controller reports to Janice Mead.	
d. The accounting department has experienced a high rate of turnover of key personnel.	
e. TWD's bank has a loan officer who meets regularly with TWD's CEO and controller to monitor TWD's financial performance.	
f. TWD's employees are paid biweekly.	
g. TWD has such a strong financial presence in its industry to allow it often to dictate the terms or conditions of transactions with its suppliers.	
h. During 20X1, TWD changed its method of preparing its financial statements from the cash basis to generally accepted accounting principles.	
i. During 20X1, TWD sold one-half of its controlling interest in United Equipment Leasing (UEL) Co. TWD retained significant influence over UEL.	
j. During 20X1, litigation filed against TWD from an action 10 years ago that alleged that TWD discharged pollutants into state waterways was dropped by the state. Loss contingency disclosures that TWD included in prior years' financial statements are being removed from the 20X1 financial statements.	
k. During December 20X1, TWD signed a contract to lease disposal equipment from an entity owned by Janice Mead's parents. This related party transaction is not disclosed in TWD's notes to the 20X1 financial statements.	
l. During December 20X1, TWD completed a barter transaction with a municipality. TWD removed waste from the municipally owned site and acquired title to another contaminated site at below market price. TWD intends to service this new site in 20X2.	
m. During December 20X1, TWD increased its casualty insurance coverage on several pieces of sophisticated machinery from historical cost to replacement cost.	
n. Inquiries about the substantial increase in revenue TWD recorded in the fourth quarter of 20X1 disclosed a new operating policy. TWD guaranteed to several municipalities that it would refund the federal and state funding paid to TWD if any municipality fails a federal or state site clean-up inspection in 20X2.	
o. An initial public offering of TWD's stock is planned for late 20X2.	

LO 6-2, 3, 4, 5, 6, 7 6-41. **Simulation**

You have been hired to perform the audit of Hanmei Inc.'s financial statements. When planning such an audit, you often may need to access the profession's auditing standards to perform research. For each of the following circumstances, select the topic most closely related in the Professional Standards Topics below. A topic may be selected once, more than once, or not at all.

Transactions

- Possible risk factors related to misappropriation of assets.
- The relationship between materiality used for planning versus evaluation purposes.
- Hanmei Inc. has transactions with the corporation president's brother.
- Comparing a client's unaudited results for the year with last year's audited results.
- Requirements relating to identifying violations of occupational safety and health regulations.

- f. The need to “brainstorm” among audit team members about how accounts could be intentionally misstated.
- g. Details on considering design effectiveness of controls.
- h. The importance of considering the possibility of overstated revenues (e.g., through premature revenue recognition).

Professional Standards Topics

- 1. Analytical procedures.
- 2. Materiality in planning and performing an audit.
- 3. Consideration of fraud in a financial statement audit.
- 4. Understanding the entity and its environment and assessing the risks of material misstatement.
- 5. Consideration of laws and regulations.
- 6. Management representations.
- 7. Related parties.

- LO 6-4, 5** 6-42. Assume the following general flow of documents in an accounting system. Reply to the following questions:



- a. The auditors are concerned about source documents that reflect valid transactions that have not been recorded in the journals. Which procedure would be most effective?
 - (1) Trace *from* source documents *to* journals.
 - (2) Vouch *from* journals *to* source documents.
 - (3) Either (1) or (2).
- b. The auditors are concerned about transactions that have been recorded in the journals (and subsequently in the ledgers) that are not valid—that is, a transaction is recorded, but it did not actually occur (e.g., a fraudulent overstatement of sales). Which procedure would be most effective?
 - (1) Trace *from* source documents *to* journals.
 - (2) Vouch *from* journals *to* source documents.
 - (3) Either (1) or (2).
- c. The auditors are concerned about transactions that have been recorded for improper amounts. Which procedure would be most effective?
 - (1) Trace *from* source documents *to* journals.
 - (2) Vouch *from* journals *to* source documents.
 - (3) Either (1) or (2).
- d. Tracing from source documents to journals most directly tests:
 - (1) Completeness (understatements).
 - (2) Existence (overstatements).
- e. Vouching from journals (or ledgers) to source documents most directly tests:
 - (1) Completeness (understatements).
 - (2) Existence (overstatements).

- LO 6-5** 6-43. Answer the following questions relating to the assessment of the risk of material misstatements.

- a. Which of the following is most likely to be close to the upper end of the spectrum of inherent risk?
 - (1) A relevant assertion.
 - (2) A significant risk.
 - (3) A reasonably possible misstatement.
 - (4) An inherent risk factor.

- b. Absent other changes, an increase in the likelihood of occurrence will have what effect on an assertion's placement on the spectrum of inherent risk?
 - (1) Decrease.
 - (2) Increase.
 - (3) Indeterminate.
 - (4) No effect.
- c. Absent other changes, an increase in likelihood of occurrence and a decrease in its magnitude will have what effect on an assertion's placement on the spectrum of inherent risk?
 - (1) Decrease.
 - (2) Increase.
 - (3) Indeterminate.
 - (4) No effect.
- d. The spectrum of inherent risk is a concept most directly relating to:
 - (1) Determination of materiality levels.
 - (2) Only audits of small public companies.
 - (3) Significant risks relating to accounts, transactions, and balances.
 - (4) Whether inherent risk should be considered on an audit.
- e. In identifying significant risks, which is *least* likely to be considered?
 - (1) Inherent risk factors.
 - (2) Internal control.
 - (3) Likelihood relating to inherent risk.
 - (4) Magnitude relating to inherent risk.
- f. Which of the following is correct relating to significant risks?
 - (1) Analytical procedures are applied in identifying them.
 - (2) Detection risk determines their existence.
 - (3) Their existence depends upon a consideration of their likelihood and magnitude.
 - (4) They exist when their likelihood of occurrence is at least remote.

LO 6-2, 3 6–44. Multiple Choice Questions

- a. While performing an audit of a nonpublic company, the auditors receive a request from the president that the company no longer desires an audit and wants you to change the engagement to a review. In which of the following situations would the auditors be *least* likely to conclude that reasonable justification for the change exists?
 - (1) The client does not want confirmations to be sent to customers.
 - (2) The client has not had its financial statements audited in the past and chose to have one without understanding the nature of audit requirements.
 - (3) A bank requirement of receiving audited client financial statements relating to a loan it provided the client, the primary reason for the audit, has been eliminated.
 - (4) The planning of the audit has just begun and the client's deteriorating financial position makes it cost prohibitive.
- b. While performing an audit of a nonpublic company, the auditors receive a request from the president that the company no longer desires an audit and wants you to change the engagement to a review. In considering the request, the auditors have concluded that there is no reasonable justification for the change; also management will not allow continuation of the audit. Which of the following is not a likely action to be taken by the auditors?
 - (1) Communicate summarized details of the matter to other auditors in the region.
 - (2) Communicate the circumstances to those charged with governance.
 - (3) Determine whether there are legal or contractual requirements to communicate the circumstances to other parties (e.g., owners or regulators).
 - (4) Withdraw from the audit, unless prohibited by law or regulation.

c. In communicating the overall audit strategy to the audit committee, the auditors are *least* likely to discuss:

- (1) Approach to considering internal control.
- (2) Application of the restricted assurance concept in the audit.
- (3) Assessment of the nature of specialized skills needed to perform the audit.
- (4) Plans to use the work of internal auditors.

d. When considering a significant risk, the auditors consider the risk's:

	Likelihood	Magnitude
(1)	Yes	No
(2)	Yes	Yes
(3)	No	Yes
(4)	No	No

e. Which of the following is correct concerning performing certain audit procedures remotely rather than on the client's premises?

- (1) Remote auditing is limited to situations in which auditing on the client's premises is not possible.
- (2) The auditors should carefully determine which procedures can effectively be performed remotely and any procedures that may only be performed on the client premises.
- (3) Typically, any procedure is as effective when performed remotely or on the client's premises.
- (4) Remote auditing is not allowed.

**LO 6-1, 2, 3, 4,
5, 6, 7, 8**

6-45
All

For each definition (or portion of a definition) in the first column, select the term that most closely applies. Each term may be used only once or not at all.

Definition (or Portion)	Term
a. Representations by management that are communicated, explicitly or implicitly, in the financial statements.	1. Audit plan
b. A description of the nature, timing, and extent of the audit procedures to be performed.	2. Assertions
c. An estimate of the time required to perform each step in the audit.	3. Audit risk
d. The purpose of this document is to avoid misunderstandings between the auditors and the client.	4. Business risk
e. The risk of material misstatement of an assertion about an account without considering internal control.	5. Control risk
f. At the overall engagement level, this is the risk that the auditors may unknowingly fail to appropriately modify their opinion on financial statements that are materially misstated.	6. Engagement letter
g. An identified risk that requires special audit consideration.	7. Inherent risk
h. A risk that threatens management's ability to achieve the organization's objectives.	8. Maximum possibility
i. A representation by management embodied in the financial statements that has at least a reasonable possibility of being materially misstated.	9. Reasonable possibility
j. A possibility that is more than remote.	10. Relevant assertion.
	11. Representation letter
	12. Significant risk
	13. Survival risk
	14. Time budget

Problems

LO 1, 2, 3

- 6-46. You are invited by John Bray, the president of Cheviot Corporation, to discuss with him the possibility of your conducting an audit of the company. The corporation is a small, closely held manufacturing organization that appears to be expanding. No previous audit has been performed by independent certified public accountants. Your discussions with Bray include an analysis of the recent monthly financial statements, inspection of the accounting records, and discussion of policies with the chief accountant. You also are taken on a guided tour of the plant by the president. He then makes the following statement:

Before making definite arrangements for an audit, I would like to know about how long it will take and about how much it will cost. I want quality work and expect to pay a fair price, but because this is our first experience with independent auditors, I would like a full explanation as to how the cost of the audit is determined. Will you please send me a memorandum covering these points?

Write the memorandum requested by John Bray.

LO 6-3, 4, 7

- 6-47. Precision Industries Inc. is a manufacturer of electronic components. When a purchase order is received from a customer, a sales clerk prepares a serially numbered sales order and sends copies to the shipping and accounting departments. When the merchandise is shipped to the customer, the shipping department prepares a serially numbered shipping advice and sends a copy to the accounting department. Upon receipt of the appropriate documents, the accounting department records the sale in the accounting records. All shipments are *FOB shipping point*.
- How can the auditors determine whether Precision Industries Inc. has made a proper year-end cutoff of sales transactions?
 - Assume that all shipments for the first five days of the following year were recorded as occurring in the current year. If not corrected, what effect will this cutoff error have upon the financial statements for the current year?

Ethics Case

LO 6-2, 6



- 6-48. Tammy Potter, a new partner with the regional CPA firm of Tower & Tower, was recently appointed to the board of directors of a local civic organization. The chairman of the board of the civic organization is Lewis Edmond, who is also the owner of a real estate development firm, Tierra Corporation.

Potter was quite excited when Edmond indicated that his corporation needed an audit and he wished to discuss the matter with her. During the discussion, Potter was told that Tierra Corporation needed the audit to obtain a substantial amount of additional financing to acquire another company. Presently, Tierra Corporation is successful, profitable, and committed to growth. The audit fee for the engagement should be substantial.

Because Tierra Corporation appeared to be a good client prospect, Potter tentatively indicated that Tower & Tower wanted to do the work. Potter then mentioned that Tower & Tower's quality control policies require an investigation of new clients and approval by the managing partner, Lee Tower.

Potter obtained the authorization of Edmond to make the necessary inquiries for the new client investigation. Edmond was found to be a highly respected member of the community. Also, Tierra Corporation was highly regarded by its banker and its attorney, and the Dun & Bradstreet report on the corporation reflected nothing negative.

As a final part of the investigation process, Potter contacted Edmond's former tax accountant, Bill Turner. Potter was surprised to discover that Turner did not share the others' high opinion of Edmond. Turner related that on an IRS audit 10 years ago, Edmond was questioned about the details of a large capital loss reported on the sale of a tract of land to a trust. Edmond told the IRS agent that he had lost all the supporting documentation for the transaction and that he had no way of finding out the names of the principals of the trust. A search by an IRS auditor revealed that the land was recorded in the name of Edmond's married daughter and that Edmond himself was listed as the trustee. The IRS disallowed the loss and Edmond was assessed a civil fraud penalty. Potter was concerned about these findings, but eventually concluded that Edmond had probably matured to a point where he would not engage in such activities.

- Present arguments supporting a decision to accept Tierra Corporation as an audit client.
- Present arguments supporting a decision *not* to accept Tierra Corporation as an audit client.
- Assuming that you are Lee Tower, set forth your decision regarding acceptance of the client, identifying those arguments from part (a) or part (b) that you found most persuasive.

Research Cases

LO 6-2, 3, 4, 5



- 6-49 SEC filings of certain public companies can be accessed from EDGAR (Electronic Data Gathering, Analysis, and Retrieval system), which has the following Internet address: www.sec.gov/edgar.shtml

- Use EDGAR to locate a company in the software industry.
- Access the latest Form 10-K for the company and read the "Management's Discussion and Analysis" section.
- Describe four significant business risks of the company as described in its "Management's Discussion and Analysis."

LO 6-3



- 6-50 Perform an Internet search to access the text of the Securities Exchange Act of 1934. Read and summarize the internal control requirements of Section 13(b)(2) of the act.

Appendix 6A

Audit Data Analytics

Audit data analytics (ADAs) involve the analysis of patterns, identification of anomalies, or extraction of other useful information in data underlying or related to the subject matter of an audit through analysis, modeling, or visualization. Audit data analytic techniques can be used to perform risk assessment, tests of controls, substantive procedures, or procedures to form an overall conclusion on the financial statements. In this appendix, we provide an overview of the steps involved in performing audit data analytics and illustrations of its use at the various stages of the audit.

Steps Involved in Performing Audit Data Analytics

In applying audit data analytics in any of these stages in the audit, the auditors might use the following steps:

Plan the audit data analytic. In planning the ADA, the auditors will (1) select the control objectives or assertions related to the financial statement items, accounts, or disclosures; (2) determine the objectives of the procedures and the population to be analyzed; and (3) select the ADA technique(s) best suited for the intended purposes and objectives.

Assess and prepare the data for analysis. In some cases, cleansing or scrubbing of the data may be needed before meaningful analysis may be performed. Data preparation is the process of identifying data formats or errors that may affect the validity of the analysis. As an example, auditors often pull data from multiple sources and that data may have different formats for dates, codes for types of data, and numeric formats. Such differences are often easily resolved by reformatting the data. However, in some situations, data incompatibility issues may require significant cleansing performed by specialists. When difficulties are encountered because the data have numerous errors, the auditors may question whether the related controls over the data are operating effectively and they may need to use another type of audit procedure.

Assess the relevance and reliability of the data. The auditors should consider whether the data is relevant and sufficiently reliable to meet the objectives of the procedure. In considering the relevance of the data, the auditors should evaluate the relationship between the data and the related control objective, risk, or account. As an example, if the auditors are assessing the completeness assertion for an account (e.g., sales) that will affect the type of data selected for the procedure, selecting from shipping documents or data would be appropriate to test the completeness assertion.

In assessing the reliability of the data, the auditors will consider the nature of the data and its source, format, timing, extent, and level of aggregation. In essence, the auditors evaluate the accuracy and completeness of the data for the purpose and objectives of the procedure. If the data is from an internal source, the auditors will consider whether the controls over the data provide sufficient assurance of the data reliability. If the data is from an external source, the auditors will consider the authority of the organization providing it as well as the process used to develop the data.

Perform the ADA. A wide variety of ADA techniques are used by auditors, such as trend analysis, analysis of various characteristics of recorded transactions, depicting relationships among data from multiple sources, and predictive modeling. If the auditors conclude that the ADA has been properly designed and performed, they should consider the results.

Evaluate the results. If the ADA has achieved its intended purpose and objectives, the auditors may accept the results and continue with the audit. Otherwise, they may have

to perform other procedures to achieve the objectives. If a procedure was designed to test controls, they will consider the results in their assessment of control risk. If the procedure was designed to assess risk or as a substantive procedure, the auditors will follow up on items warranting investigation by performing additional procedures.

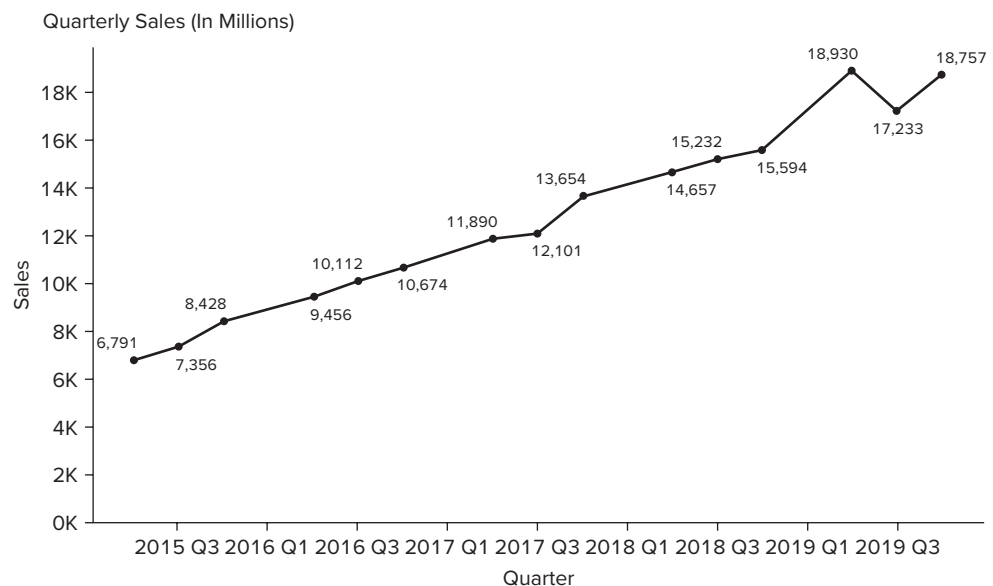
Document the ADA. The documentation should be sufficient to enable an experienced auditor, with no previous connection with the audit, to understand the nature, timing, and extent of the ADA; the results and evidence obtained; significant findings; conclusions reached; and significant professional judgments made in reaching the conclusions.

ADAs in Risk Assessment and Forming an Overall Conclusion

Risk assessment procedures are the procedures performed to obtain an understanding of the entity and its environment, including internal control, to identify and assess risks of material misstatement of financial statement assertions. Similar procedures at the conclusion of the audit are used to identify any unusual relationships or risks that were not adequately addressed during the audit. Audit data analytics are particularly useful at these stages of the audit.

Two common examples of ADA techniques used in risk assessment include

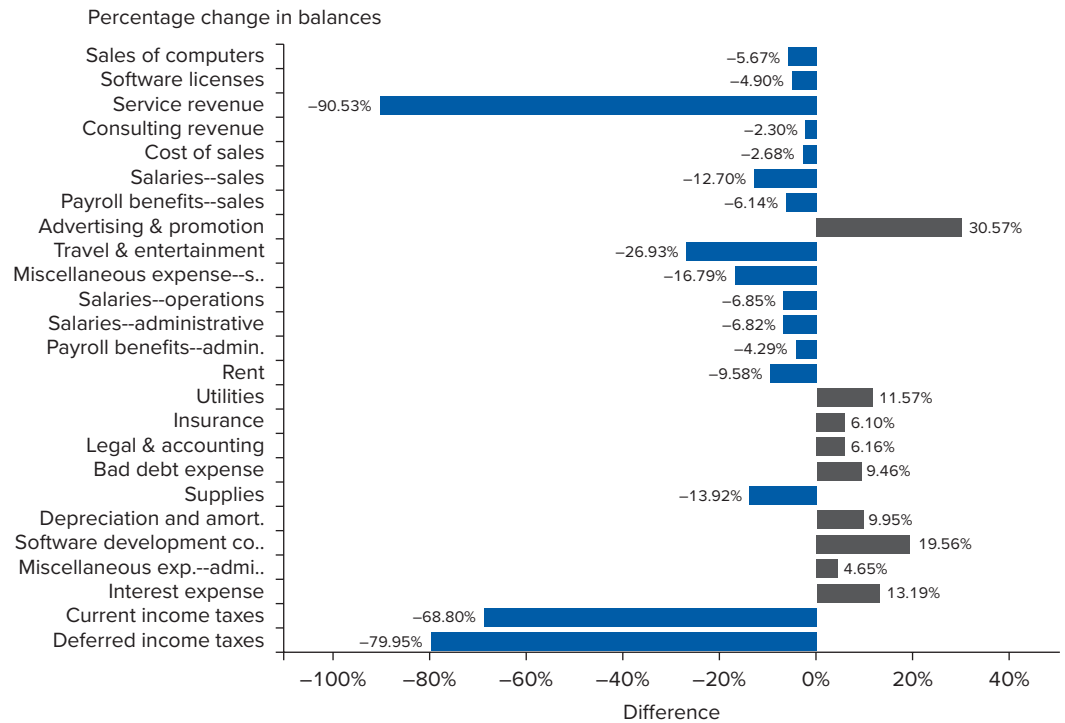
1. **Trend analysis**, which is a technique used to identify unusual relationships based on trends over time. For example, the auditors may attempt to identify risks of misstatement of revenue by examining the change in revenue over time, as illustrated in the figure below.



Of particular interest to the auditors would be the significant departure from the trend in the second and third quarters of 2019. This might imply a greater risk of overstatement of revenue in those two quarters.

2. **Analyzing general ledger fluctuations**, which is a technique used to identify unusual ledger balances by comparing the current-year balance with the prior-year balance, as illustrated in the following chart.

Any unexpected fluctuations can be easily identified and might be indicative of a misstatement of the account. As an example, the auditors may want to investigate why sales in all categories are falling (particularly service revenue) and advertising and promotion expense is increasing, as well as the implications of the situation.



ADAs in Tests of Controls

Tests of controls are performed to determine the operating effectiveness of controls. Historically, auditors have performed numerous manual tests of transactions to test for transaction authorization, approval, classification, and recording. Some of these tests may be conducted more efficiently and effectively with ADAs. Assume the auditors are performing tests of controls over cash disbursements for purchases and want to determine that purchases and vendors are approved, goods were received, and the prices paid agree with prices authorized by the purchasing department. Assuming the general controls over the accounting system are effective, the auditors can easily test 100 percent of the transactions for approval, authorization, receipt, and pricing. Generalized audit software can identify any transactions that exhibit a deviation from required controls.

Below is an IDEA analysis of purchases from unauthorized vendors (supplier number blank) and unapproved purchases (purchase authorization blank). Both of these tests of controls are aimed at addressing proper authorization and approval of the recorded purchases.

Direct Extraction

Records to extract: ☒ All Starting record #: 1

☐ Range Ending record #: 999

☐ Create a virtual database

Database order: No index

	File Name	Criteria
1	Unauthorized Vendor	@IsBlank(SUPPNO)
2	Purchase Not Authorized	@IsBlank(PURCHASE_AUTHORIZED)
3		

OK

Create Fields

Fields

Delete

Cancel

Help

IDEA

Wellington Purchases File-AC...		Unauthorized Vendor						
	SUPPNO	PAYEE	INVOICE	INV_DATE	AMOUNT	CHECK	PAY_DATE	PURCHASE_AUTHORIZED
1		A Raid	3501124	20191020	14,288.57	701913	20191116	BC
2		A Raid	3501040	20190114	38,149.16	701032	20190210	BC

IDEA

Wellington Purchases File-AC...		Unauthorized Vendor						
		Purchase Not Authorized						
	SUPPNO	PAYEE	INVOICE	INV_DATE	AMOUNT	CHECK	PAY_DATE	PURCHASE_AUTHORIZED
1	B008	Anderson Inc.	3501050	20190129	22,880.98	701103	20190228	
2	8006	Jenner Corp.	3501121	20190917	15,045.62	701811	20191016	
3	G025	Wilson Inc.	871552BUZ	20190925	76,758.03	701838	20191023	
4	G025	Wilson Inc.	871560BUZ	20191024	35,462.59	701934	20191121	

IDEA

The auditors will followup on the unauthorized vendors and purchases. In both cases, they will attempt to determine why the controls broke down and the implications. Vouching the transactions to determine that the goods purchased were received and represented purchases for valid business purposes will also generally be considered necessary.

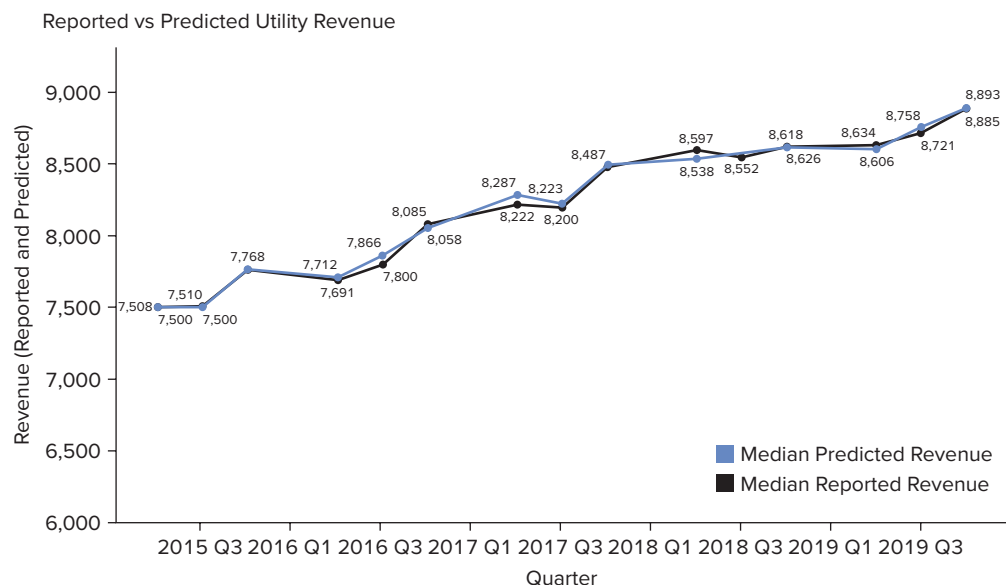
ADAs in Substantive Analytical Procedures

Analytical procedures involve evaluations of financial statement information by a study of relationships among financial and nonfinancial data. If the amounts and relationships are as expected, the auditors may obtain evidence about the reasonableness of accounts and classes of transactions. The process of performing substantive analytical procedures includes

1. Develop an expectation of an account (or ratio) balance.
2. Determine the amount of difference from the expectation that can be accepted without investigation.
3. Compare the company's account (ratio) balance with the expectation.
4. Investigate and evaluate significant differences from the expectation.

With the use of ADA techniques, the expectations developed for the procedure can be more accurate and precise, thereby providing more evidence about the account and class of transactions.

While the ADAs used for substantive analytical procedures may consist of something as simple as trend analysis, more often auditors use more sophisticated techniques, such



as multiple regression. As an example, the auditors might use customer square footage, type of customers, and average temperature to estimate the revenue generated by a utility company. Once a regression model is developed, the auditors can use the formula developed from the model to predict revenue amounts. This technique is referred to as predictive analysis and is illustrated on the previous page.

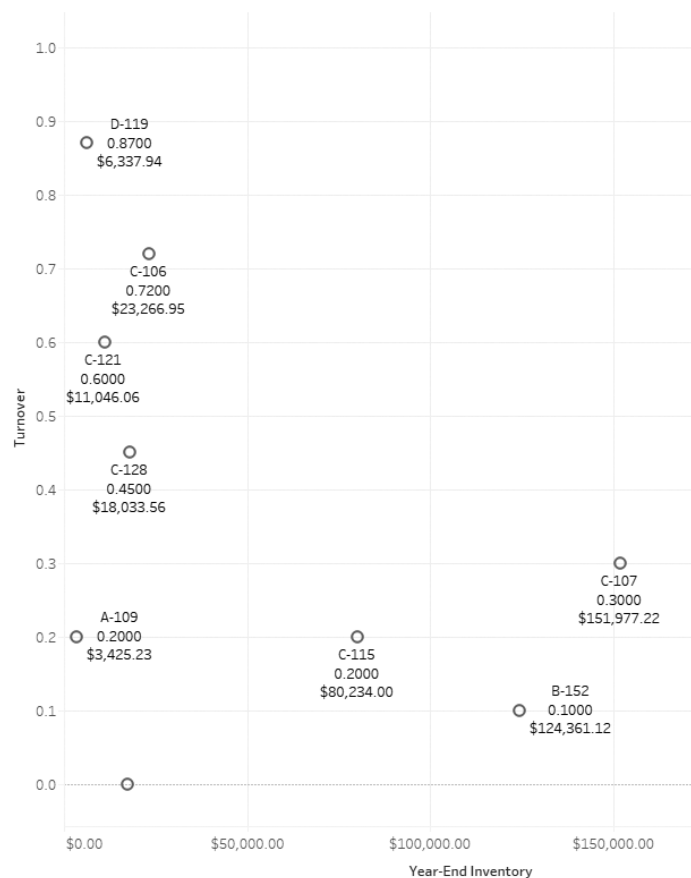
When the predicted value departs significantly from the actual amount, the auditors will investigate and perform additional procedures to determine whether the account is misstated.

ADAs in Substantive Tests of Details

When ADAs are used for substantive tests of details, the procedures may involve comparing one or more electronic records with others to identify potential misstatements. As an example, the auditors might compare sales invoice amounts to the amounts of subsequent cash receipts to identify misstatement of sales transactions. Alternatively, sales transactions might also be tested by matching the data from sales invoices to shipping data and price lists. Since these tests are similar to those used to perform detailed tests of controls (as described earlier), the auditors often perform them as dual-purpose tests. Similar to the tests of controls, ADAs allow the auditors to test 100 percent of the transactions for misstatements. If the auditors encounter a larger-than-expected number of misstatements, they should consider the implications for the effectiveness of the related internal controls.

The auditors may also use ADAs to identify potentially misstated amounts that have certain characteristics. For example, if the auditors are looking for potential obsolete (overvalued) inventory items, they may use ADAs to focus on high-value items that have low turnover rates. The chart on the prior page is a cluster diagram of all inventory items with a turnover rate of 1.0 or less organized by the dollar amount of the ending balance.

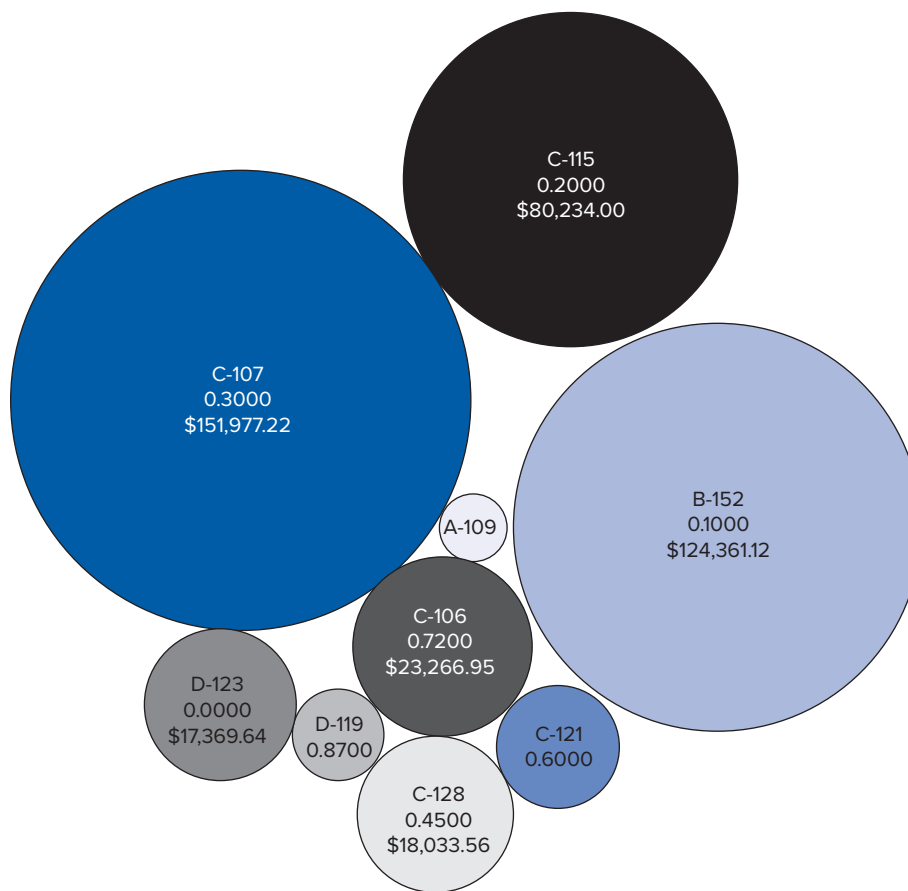
Inventory Items with Turnover of Less Than 1.00



In this case, the auditors would focus on the items on the bottom right side of the chart: high-value items with very low turnover rates.

The auditors might also display the data as a bubble chart, as shown below. In this chart, the size of the bubble reflects the dollar value of the ending inventory and the shade of color reflects the turnover rate. Lighter (darker) colors reflect lower (higher) turnover rates. Therefore, the auditors would focus on the larger and lighter bubbles.

Inventory Items with Turnover of Less than 1.00



Appendix 6B



Examples of Fraud Risk Factors

Risk Factors Relating to Misstatements Arising from Fraudulent Financial Reporting

INCENTIVES AND PRESSURES

1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by):
 - a. High degree of competition or market saturation, accompanied by declining margins.
 - b. High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
 - c. Significant declines in customer demand and increasing business failures in either the industry or overall economy.

- d. Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent.
 - e. Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.
 - f. Rapid growth or unusual profitability, especially compared to that of other companies in the same industry.
 - g. New accounting, statutory, or regulatory requirements.
2. Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:
 - a. Profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties (particularly expectations that are unduly aggressive or unrealistic), including expectations created by management in, for example, overly optimistic press releases or annual report messages.
 - b. Need to obtain additional debt or equity financing to stay competitive—including financing of major research and development or capital expenditures.
 - c. Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements.
 - d. Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.
 3. Information available indicates that management or the board of directors' personal financial situation is threatened by the entity's financial performance arising from the following:
 - a. Significant financial interests in the entity.
 - b. Significant portions of their compensation (e.g., bonuses, stock options, and earn-out arrangements) being contingent upon achieving aggressive targets for stock price, operating results, financial position, or cash flow.
 - c. Personal guarantees of debts of the entity.
 4. There is excessive pressure on management or operating personnel to meet financial targets set up by the board of directors or management, including sales or profitability incentive goals.

OPPORTUNITIES

1. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:
 - a. Related party transactions that are also significant unusual transactions.
 - b. Significant transactions with related parties whose financial statements are not audited or audited by another firm.
 - c. A strong financial presence or ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions.
 - d. Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate.
 - e. Significant or highly complex transactions or significant unusual transactions, especially those close to period end that pose difficult "substance over form" questions.
 - f. Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.
 - g. Significant bank accounts or subsidiary or branch operations in tax-haven jurisdictions for which there appears to be no clear business justification.
 - h. Contractual arrangements lacking a business purpose.
2. There is ineffective monitoring of management as a result of the following:
 - a. Domination of management by a single person or small group (in a non-owner-managed business) without compensating controls.
 - b. Ineffective board of directors or audit committee oversight over the financial reporting process and internal control.
 - c. The exertion of dominant influence by or over a related party.

3. There is a complex or unstable organizational structure, as evidenced by the following:
 - a. Difficulty in determining the organization or individuals that have controlling interest in the entity.
 - b. Overly complex organizational structure involving unusual legal entities or managerial lines of authority.
 - c. High turnover of senior management, counsel, or board members.
4. Internal control components are deficient as a result of the following:
 - a. Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required).
 - b. High turnover rates or employment of ineffective accounting, internal audit, or information technology staff.
 - c. Ineffective accounting and information systems, including situations involving reportable conditions.

ATTITUDES AND RATIONALIZATIONS

Risk factors reflective of attitudes and/or rationalizations by board members, management, or employees that allow them to engage in and/or justify fraudulent financial reporting may not be susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from fraudulent financial reporting. For example, auditors may become aware of the following information that may indicate a risk factor:

1. Ineffective communication, implementation, support, or enforcement of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards.
2. Nonfinancial management's excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates.
3. Known history of violations of securities laws or other laws and regulations, or claims against the entity, its senior management, or board members alleging fraud or violations of laws and regulations.
4. Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend.
5. A practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.
6. Management failing to correct known significant deficiencies on a timely basis.
7. An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
8. Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
9. A strained relationship between management and the current or predecessor auditor, as exhibited by the following:
 - a. Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
 - b. Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report.
 - c. Formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with the board of directors or audit committee.
 - d. Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

Risk Factors Relating to Misstatements Arising from Misappropriation of Assets

INCENTIVES AND PRESSURES

1. Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.
2. Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:
 - a. Known or anticipated future employee layoffs.
 - b. Recent or anticipated changes to employee compensation or benefit plans.
 - c. Promotions, compensation, or other rewards inconsistent with expectations.

OPPORTUNITIES

1. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:
 - a. Large amounts of cash on hand or processed.
 - b. Inventory items that are small in size, of high value, or in high demand.
 - c. Easily convertible assets, such as bearer bonds, diamonds, or computer chips.
 - d. Fixed assets that are small in size, marketable, or lacking observable identification of ownership.
2. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:
 - a. Inadequate segregation of duties or independent checks.
 - b. Inadequate management oversight of employees responsible for assets (e.g., inadequate supervision or monitoring of remote locations).
 - c. Inadequate job applicant screening of employees with access to assets.
 - d. Inadequate record keeping with respect to assets.
 - e. Inadequate system of authorization and approval of transactions (e.g., in purchasing).
 - f. Inadequate physical safeguards over cash, investments, inventory, or fixed assets.
 - g. Lack of complete and timely reconciliations of assets.
 - h. Lack of timely and appropriate documentation of transactions (e.g., credits for merchandise returns).
 - i. Lack of mandatory vacations for employees performing key control functions.
 - j. Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.
 - k. Inadequate access controls over automated records, including controls over and review of computer systems event logs.

ATTITUDES AND RATIONALIZATIONS

Risk factors reflective of employee attitudes and/or rationalizations that allow them to justify misappropriations of assets are generally not susceptible to observation by the auditor. Nevertheless, the auditor who becomes aware of the existence of such information should consider it in identifying the risks of material misstatement arising from misappropriation of assets. For example, auditors may become aware of the following attitudes or behavior of employees who have access to assets susceptible to misappropriation:

1. Disregard for the need for monitoring or reducing risks related to misappropriation of assets.
2. Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies.
3. Behavior indicating displeasure or dissatisfaction with the company or its treatment of the employee.
4. Changes in behavior or lifestyle that may indicate assets have been misappropriated.

Appendix 6C

Illustrative Audit Case: Keystone Computers & Networks Inc.

Part I: Audit Planning

The Keystone Computers & Networks Inc. (KCN) case is used throughout the text to illustrate audit procedures and methodology. KCN is a company that sells and installs computer workstations and networking software to business customers. The CPA firm of Adams, Barnes & Co. has audited the financial statements of KCN for the past three years. This part of the case illustrates selective audit planning working papers prepared by the staff of Adams, Barnes & Co. for this year's audit. You should read through the information to obtain an understanding of the nature of the information that is important to planning an audit engagement. The working papers include

- The balance sheet and income statement for the company for the prior year, 20X4.
- A trial balance for 12/31/X5, with comparative amounts for 12/31/X4.
- The analytical ratios working paper, partially completed.
- The overall audit strategy for the audit of the financial statements for the year ended 12/31/X5.
- A fraud risk assessment.
- The engagement letter for the audit, presented in Figure 6.2 of this chapter.

KEYSTONE COMPUTERS & NETWORKS INC.

Balance Sheet December 31, 20X4

Assets	
Current Assets	
Cash	\$ 53,964
Trade receivables, less allowance for doubtful accounts of \$96,000	8,438,524
Accounts receivable—officers	57,643
Inventory	1,234,589
Prepaid expenses	156,900
Total current assets	\$ 9,941,620
Equipment and leasehold improvements, at cost	
Equipment and furniture	\$ 1,090,634
Leasehold improvements	98,900
	\$ 1,189,534
Less accumulated depreciation	(250,987)
	\$ 938,547
Intangible assets net of amortization	\$ 1,000,000
	<u>\$ 11,880,167</u>
Liabilities and Stockholders' Equity	
Current Liabilities	
Line of credit	\$ 6,612,550
Accounts payable	1,349,839
Current maturities of capital lease obligations	43,200
Accrued expenses	178,900
Total current liabilities	\$ 8,184,489
Capital lease obligations, less current maturities	\$ 456,700
Total liabilities	\$ 8,641,189
Stockholders' equity	
Common stock, \$1 par value; 1,000,000 shares authorized; 200,000 shares issued and outstanding	\$ 200,000
Additional paid-in capital	423,500
Retained earnings	2,615,478
	<u>\$ 11,880,167</u>

KEYSTONE COMPUTERS & NETWORKS INC.**Statements of Income and Retained Earnings****Year Ended December 31, 20X4**

Net sales			\$96,459,566
Cost of goods sold			<u>74,122,435</u>
Gross profit			\$22,337,131
Selling expenses:			
Salaries	\$ 3,167,889		
Payroll benefits and taxes	913,456		
Advertising and promotion	1,200,786		
Travel and entertainment	609,788		
Miscellaneous	<u>334,890</u>		
		\$ 6,226,809	
Operating and administration expenses:			
Operating salaries	\$ 4,878,900		
Administrative salaries	4,234,234		
Payroll benefits and taxes	1,812,344		
Rent	797,800		
Utilities	210,495		
Insurance	356,890		
Legal and accounting	457,577		
Bad debt	234,500		
Supplies	556,345		
Depreciation and amortization	334,565		
Software development	289,100		
Miscellaneous	<u>234,556</u>		
		\$14,397,306	
Total selling, operating, and administrative expenses			<u>\$20,624,115</u>
Operating income			\$ 1,713,016
Interest expense			<u>421,344</u>
Income before income taxes			\$ 1,291,672
Income taxes:			
Current		\$ 256,765	
Deferred		<u>45,632</u>	
			302,397
Net income			<u>\$ 989,275</u>
Retained earnings, January 1, 20X4			\$ 1,626,203
Retained earnings, December 31, 20X4			<u><u>\$ 2,615,478</u></u>

KEYSTONE COMPUTERS & NETWORKS INC.					Prepared by	WL
Working Trial Balance					Reviewed by	
For the Period Ended December 31, 20X5					Page 1	
Account #	Account Name	Prior Period Balance 12/31/X4	Unadjusted Trial Balance Dr (Cr)	Ref #	Adjustments Dr (Cr)	Adjusted Balance Dr (Cr)
1000.10	Cash—General Account	42,754	66,034			
1000.20	Cash—Special Account	9,960	10,150			
1000.30	Cash in Register	1,200	1,200			
1000.40	Petty Cash	50	50			
1050.10	Accounts receivable—trade	8,534,524	10,235,457			
1050.40	Accounts receivable—officers	57,643	84,670			
1050.90	Allowance for bad debts	(96,000)	(104,000)			
1100.10	Inventories	1,234,589	1,375,835			
1300.10	Prepaid expenses	156,900	176,456			
2050.10	Furniture and fixtures	300,980	344,900			
2050.30	Office equipment	789,654	974,676			
2050.80	Leasehold improvements	98,900	91,230			
2050.90	Accumulated depreciation	(2,50,987)	(404,560)			
2100.00	Software development cost		178,000			
2200.00	Intangible assets	1,000,000	800,000			
3050.10	Accounts payable—trade	(1,349,839)	(1,429,033)			
3100.00	Capital lease obligations—current	(43,200)	(45,675)			
3200.10	Accrued liabilities	(178,900)	(203,450)			
3300.30	Unearned service revenue		(42,300)			
3400.50	Line of credit	(6,612,550)	(8,632,105)			
4400.10	Capital lease obligations—noncurrent	(456,700)	(423,680)			
5050.10	Capital stock	(200,000)	(200,000)			
5100.10	Paid-in capital	(423,500)	(423,500)			
5700.10	Retained earnings	(1,626,203)	(2,615,478)			
5900.00	Dividends		415,000			
		989,275	229,877			
		(9,89,275)	(229,877)			
		0	0			

KEYSTONE COMPUTERS & NETWORKS INC.

Working Trial Balance
For the Period Ended December 31, 20X5

Prepared by WL

Reviewed by _____

Page 2

Account #	Account Name	Prior Period Balance 12/31/X4	Unadjusted Trial Balance Dr (Cr)	Ref #	Adjustments Dr (Cr)	Adjusted Balance Dr (Cr)
6000.10	Sales of computers	(44,890,788)	(42,345,675)			
6010.10	Software licenses	(248,900)	(236,700)			
6020.10	Service revenue	(4,567,888)	(4,325,777)			
6030.10	Consulting revenue	(46,751,990)	(45,677,899)			
7020.10	Cost of sales	74,122,435	72,134,566			
7070.10	Salaries—sales	3,167,889	2,765,677			
7070.50	Payroll benefits—sales	913,456	857,368			
7075.10	Advertising and promotion	1,200,786	1,567,889			
7080.10	Travel and entertainment	609,788	445,600			
7080.30	Miscellaneous expenses—sales	334,890	278,656			
7090.10	Salaries—operations	4,878,900	4,544,860			
7090.30	Salaries—administrative	4,234,234	3,945,670			
7090.50	Payroll benefits—administrative	1,812,344	1,734,565			
7100.10	Rent	797,800	721,345			
7140.10	Utilities	210,495	234,839			
7200.10	Insurance	356,890	378,677			
7260.30	Legal and accounting	457,577	485,767			
7320.10	Bad debt expense	234,500	256,678			
7410.10	Supplies	556,345	478,900			
7600.10	Depreciation and amortization	334,565	367,867			
7650.10	Software development	289,100	345,645			
7700.10	Miscellaneous expenses—administrative	234,556	245,456			
7800.10	Interest expense	421,344	476,899			
7900.10	Current income taxes	256,765	80,100			
7900.70	Deferred income taxes	45,632	9,150			
9000.00	P & L Summary	989,275				
		0	(229,877)			
		0	229,877			
		0	0			

KEYSTONE COMPUTERS & NETWORKS INC. Analytical Review Ratios For the Period Ended December 31, 20X5				Prepared by <u>WL</u>
				Reviewed by _____
Ratio	Ending 12/31/X5	Ending 12/31/X4	Industry	
Current ratio	1.1	1.2	1.3	
Days' sales in accounts receivable, computed with average accounts receivable	37.0	33.2	37.0	
Allowance for doubtful accounts/accounts receivable	1.0%	1.1%	—	
Bad debt expense/net sales	0.3%	0.2%	—	
Total liabilities/net worth	3.5	2.7	2.9	
Return on total assets	1.7%	8.3%	9.0%	
Return on net worth	7.5%	30.5%	29.0%	
Return on net sales	0.2%	1.0%	2.3%	
Gross profit/net sales	22.1%	23.2%	24.0%	
Selling, operating, and administrative expense/net sales	21.2%	21.4%	23.9%	
Times interest earned	1.7	4.1	5.5	

KEYSTONE COMPUTERS & NETWORKS INC. Audit Strategy December 31, 20X5			Date
Prepared by:	Warren Love (Senior)		August 14, 20X5
Reviewed by:	Karen West (Manager)		August 28, 20X5
Reviewed by:	Charles Adams (Partner)		September 5, 20X5

OVERALL AUDIT STRATEGY

OBJECTIVES OF THE ENGAGEMENT

Audit of the financial statements of Keystone Computers & Networks Inc. (KCN) for the year ended December 31, 20X5. Also, the company's debt agreement with Western Financial Services requires the company to furnish the lender a report by our firm on KCN's compliance with various restrictive debt covenants.

BUSINESS AND INDUSTRY CONDITIONS

KCN sells and installs computers and networking hardware and software to business customers and provides other information technology consulting services. KCN also has begun developing its own computer networking software to be sold as a product to its customers. The company's primary competitive strategy is to maintain a high level of technical expertise and a broad range of services.

KCN's long-term success is contingent on its ability to attract and retain qualified information technology personnel. The market for such individuals is very competitive. However, the company has a competitive advantage because of its desirable geographic location (Phoenix), which has a large number of colleges with technology programs.

The market for computers and related products is extremely competitive. KCN competes with large retailers of computers, such as Dell, HP, Microsoft, and Apple. The company also competes with other value-added resellers who provide computers and software products and consulting services directly to customers. To effectively compete, the company must be able to obtain inventories of state-of-the-art equipment on a timely basis. Because the company does not have the buying power of some of its other competitors,

it generally must charge a higher price for its products. Its customers are willing to pay the higher price because of the high level of expertise and service that the company provides.

The market for computer products and technology services is also very sensitive to economic conditions. Recent reports indicate that the U.S. economy will be challenged for the next few years. The annual growth in spending for information technology products and services is expected to be 3 percent per year for the next three years. In the past year, the company has decided to increase sales by extending credit to clients with slightly higher credit risk.

PLANNING MEETINGS

On July 20, Karen West and I met with Loren Steele, controller, and Sam Best, president, of KCN to discuss the planning of the audit for the current year. On August 2, a planning meeting was held in our office with all members of the engagement team assigned to the audit.

OWNERSHIP AND MANAGEMENT

KCN is a closely held company owned by five stockholders: Terry Keystone, Mark Keystone, John Keystone, Keith Young, and Rita Young. Terry and Mark Keystone are active members of the company's board of directors. None of the other owners take an active part in the management of the business.

OBJECTIVES, STRATEGIES, AND BUSINESS RISKS

KCN's primary business objectives are to increase revenues by 6 percent and increase net income by 8 percent each year for the next three years. Major strategies to achieve those objectives include

- Aggressive marketing of products and services through increased advertising.
- Sales to customers with a higher credit risk profile.
- New software development.

The primary business risks associated with the company's strategies include

- The U.S. economy may suffer a significant downturn.
- Competitors may engage in predatory pricing to gain market share.
- Increased advertising expenditures may not produce desired results.
- Credit losses may exceed the benefits of increased sales.
- Software development activities may not generate viable products.

The company has developed the following responses to these risks

- Careful monitoring of economy and industry conditions.
- Careful monitoring of competitor actions.
- Hiring of marketing consulting firm to evaluate the performance of advertising methods.
- Daily review of aging of accounts receivable by Loren Steele, controller.
- Use of carefully controlled software development budget.

MEASUREMENT AND REVIEW OF FINANCIAL PERFORMANCE

Management uses the following measures to monitor the company's performance:

- Inventory and receivables turnover.
- Aging of accounts receivable.
- Sales and gross margins by type of revenue.
- Net income.
- Total inventory balance.

PROCEDURES TO OBTAIN AN UNDERSTANDING OF THE CLIENT AND ITS ENVIRONMENT

The following procedures were performed to update our understanding of the client and its environment:

- Roll forward of information from the prior year's audit.
- Inquiries of management:

Loren Steele	7/20, 8/15
Sam Best	7/20, 8/16
- Reading of quarterly board of directors' meetings held on 4/05 and 7/12.
- Review of monthly performance reports for January through July.
- Industry reports—IT and consulting services.
- Review of KCN's website.
- Review of selected articles in *The Wall Street Journal*.

SIGNIFICANT RISKS

Several significant risks were noted as a result of obtaining information about KCN and its environment, including

Risk	Implications and Response
1. KCN has engaged in a strategy to sell to customers with higher credit risk.	
2. The officers of the company receive significant bonuses based on quarterly results.	

SIGNIFICANT ACCOUNTING AND AUDITING MATTERS

The company began offering for sale extended warranties on computers during the current year. We need to review the method of revenue recognition to determine whether it complies with the requirements of FASB ASC 606.

In the prior year, KCN began developing networking software products for sale. This year the company has started capitalizing certain costs of development. We need to review the method of accounting for the cost of software development to determine whether it complies with the requirements of FASB ASC 985-20-25.

In 20X3, KCN acquired for \$1,200,000 a small business accounting system (Plumbtree Systems) that it licenses to its customers. Recently, sales of the licenses for the software have begun to decline. In addition, a recent article in a trade journal ranked the system poor in relation to its competitors. This may indicate that an impairment in the value of the software may have occurred.

MATERIALITY FOR PLANNING

Because the firm has experienced steady growth in sales and earnings over the last three years, we believe that operating results are the most appropriate basis for estimating materiality for planning, as described below:

Comparison of Bases		Computation of Planning Materiality			
Financial Statement Base	Annualized for 12/31/X5	Base	Amount	Percentage	Materiality Estimate
Sales	\$92,000,000	Sales	\$92,000,000	1%	\$920,000
Total assets	13,000,000	Total assets	13,000,000	1	130,000
Pretax net income	320,000	Pretax net income	320,000	10	32,000

The range for materiality for planning is from \$32,000 to \$920,000. Based on the company's steady growth in sales and earnings and the fact that the company is not a public company, we have selected \$300,000 as a reasonable materiality amount for planning purposes. Details on account and disclosure performance materiality and tolerable misstatement amounts are provided in the related detailed documentation.

SCHEDULING AND STAFFING PLAN

Based on discussions with Ms. Steele, the following are tentative dates of importance for the audit:

Begin interim audit work	October 15, 20X5
Complete interim audit work	by November 15, 20X5
Issue management letter on interim work	by November 30, 20X5
Observe physical inventory	December 31, 20X5
Begin year-end audit work	February 1, 20X6
Complete fieldwork	by February 20, 20X6
Closing conference	February 25, 20X6
Issue audit report	by March 5, 20X6
Issue letter required by financing agreement	by March 5, 20X6
Issue updated management letter	by March 10, 20X6

Staffing time requirements for the engagement are described below:

	Assistant	Senior	Manager	Partner	Total
Interim	40	40	10	8	98
Final	40	30	15	12	97
	80	70	25	20	195

	Fraud Risk Assessment	
Client: <i>Keystone Computers & Networks, Inc.</i>		G-10 CA CA 8/14/X5
Financial Statement Date: <i>12/31/X5</i>		
Procedure	Performed by	Comments
1. Consider the results of the discussion among engagement personnel about the risk of material misstatement due to fraud.	<u>CA</u>	See G-21 for a description of the discussion.
2. Consider results of inquiries of management about the risks of fraud and how they are addressed.	<u>CA</u>	
3. Consider the results of risk assessment analytical procedures.	<u>CA</u>	
4. Consider the existence of fraud risk factors listed on G-30 through G-35.	<u>CA</u>	
5. Consider any other information that might be relevant to the risk of material misstatement due to fraud.	<u>CA</u>	
Risks of Material Misstatement Due to Fraud <i>Management may be motivated to misstate financial results due to impending sale of the company.</i>		
Responses Overall Responses <i>Risks were considered in staffing the engagement and determining the appropriate level of supervision.</i>		
Alterations of the Nature, Timing, and Extent of Further Audit Procedures <i>Risks were considered in designing audit procedures for sales and accounts receivable and inventories. (See R-6 and R-9.)</i> <i>Procedures were performed to address the risk of management override of internal controls. (See G-23–G-24.)</i>		

Appendix 6C

Problems LO 6-3

- 6C-1. Planning information for the audit of Keystone Computers & Networks Inc. appears in this appendix. Review each major section of the audit plan and briefly describe the purpose and content of the section. Organize your solution in the following manner:

Section	Purpose	Content
Objectives of the engagement	To describe the services that are to be rendered to the client.	The objectives are (1) audit of KCN's financial statements for the year ended 12/31/X5 and (2) issuance of a letter on compliance with covenants of the client's letter of credit agreement.

- LO 6-3, 4** 6C-2. In the overall audit strategy for the audit of Keystone Computers & Networks Inc. in this appendix, there is a section on significant risks. For each of the risks, identify the implications and potential responses.

- LO 6-7** 6C-3. The overall audit strategy for the audit of Keystone Computers & Networks Inc. in this appendix includes a section on significant accounting and auditing matters. The second matter described involves capitalizing the costs of developing a software program for sale.
- Research this issue and write a brief memorandum for the working papers describing the issue and summarizing the appropriate method of accounting for the development costs.
 - Based on your research, describe the major audit issue that you believe will be involved in auditing the software development costs.

- LO 6-3, 4** 6C-4. The working paper for Keystone Computers & Networks' analytical review ratios is presented in this appendix.

- Recalculate the 12/31/X5 ratios using Excel.
- After completing part (a), review the ratios and identify financial statement accounts that should be investigated because the related ratios are not comparable to prior-year ratios, industry averages, or your knowledge of the company.
- For each account identified in part (b), list potential reasons for the unexpected account balances and related ratios.

eXcel

Internal Control

Our discussion of internal control in this chapter has four major objectives: first, to explain the meaning and significance of internal control; second, to discuss the major components of a client's internal control; third, to show how auditors go about considering internal control to meet the requirements of a financial statement audit; and fourth, to provide an overview of audits of internal control performed under Section 404(b) of the Sarbanes-Oxley Act. No attempt is made in this chapter to present in detail the controls applicable to particular account balances and classes of transactions. Detailed information along those lines will be found in succeeding chapters as each phase of the audit is presented.

As discussed in Chapter 1, internal control has attained its greatest significance in large-scale business organizations. Accordingly, the major part of the discussion in this chapter is presented in terms of the large corporation. A separate section is presented at the end of the chapter, however, dealing with the problem of achieving internal control in a small business.

The Meaning of Internal Control

LO 7-1

Define what is meant by internal control.

Differences of opinion have long existed about the meaning and objectives of internal control. Until the early 1990s, many people interpreted the term **internal control** as the steps taken by a business to prevent fraud—both misappropriation of assets and fraudulent financial reporting. Others, while acknowledging the importance of internal control for fraud prevention, believed that internal control has an equal role in assuring control over business processes and compliance with laws and regulations. Such differences in interpretation also existed in the professional publications issued by the American Institute of Certified Public Accountants, the Institute of Internal Auditors Inc., and the Research Foundation of the Financial Executives Institute. It was not until the early 1990s that the various professional organizations worked together to develop a consensus on the nature and scope of internal control.

As a result of a number of instances of fraudulent financial reporting in the 1970s and early 1980s, the major accounting organizations¹ sponsored the National Commission on Fraudulent Financial Reporting (the Treadway Commission) to study the causal factors that are associated with fraudulent reporting and make recommendations to reduce the incidence of fraudulent reporting. The commission made a number of recommendations that directly addressed internal control. For example, it emphasized the importance of a competent and involved audit committee and an active and objective internal audit function in preventing fraudulent practices. It also called on the sponsoring organizations to work together to integrate the various internal control concepts and definitions in

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 7-1** Define what is meant by internal control.
- LO 7-2** Describe the major components of a client's internal control, explain the major limitations of internal control, and distinguish internal control from enterprise risk management.
- LO 7-3** Describe the auditors' consideration of internal control.
- LO 7-4** Discuss the techniques used by auditors to obtain an understanding of internal control.
- LO 7-5** Explain how internal control relates to a financial statement audit.
- LO 7-6** Describe the major types of tests of controls.
- LO 7-7** Describe the auditors' responsibility for communicating control-related matters.
- LO 7-8** Describe the nature of the audits performed under Section 404(b) of the Sarbanes-Oxley Act of 2002.

¹ The sponsoring organizations include the American Institute of Certified Public Accountants, the American Accounting Association, the Financial Executives Institute, the Institute of Internal Auditors Inc., and the Institute of Management Accountants.

order to develop common criteria to evaluate internal control. Accordingly, the Committee of Sponsoring Organizations (COSO) commissioned a study to

- Establish a common definition of internal control to serve the needs of different parties.
- Provide a standard against which businesses and other entities can assess their control systems and determine how to improve them.

The COSO framework defines internal control as [emphasis added]:

A process, effected by the entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting and compliance.

COSO's definition of internal control emphasizes that internal control is a *process*, or a means to an end, and not an end in and of itself. The process is effected by individuals, not merely policy manuals, documents, and forms. By including the concept of *reasonable assurance*, the definition recognizes that internal control cannot realistically provide absolute assurance that an organization's objectives will be achieved. Reasonable assurance recognizes that the cost of an organization's internal control should not exceed the benefits expected to be obtained.

Finally, the definition of internal control is comprehensive in that it addresses the achievement of *objectives* in the areas of effectiveness and efficiency of operations, internal and external reporting, and compliance with laws and regulations. It encompasses the methods by which top management delegates authority and assigns responsibility for such functions as selling, purchasing, production, financing, and accounting. Internal control also includes the program for preparing, verifying, and distributing to various levels of management those current reports and analyses that enable executives to maintain control over the variety of activities and functions that are performed in a large organization. The use of monitoring techniques, production standards, inspection laboratories, time and motion studies, and employee training programs involves engineers and many others far removed from accounting and financial activities; yet all of these programs and activities are a part of internal control.

In the three categories of objectives of internal control—reporting, operations, and compliance—the COSO framework states that a series of control objectives and sub-objectives exists. To illustrate this concept, consider internal control over financial reporting. At the top level, the overall objective is to prepare and issue reliable financial information. At the very detailed level, as applied to sales transactions, COSO illustrates the following control objectives (subobjectives):

1. All sales transactions that occur are recorded on a timely basis.
2. Sales transactions are recorded at correct amounts in the right accounts.
3. Sales transactions are accurately and completely summarized in the company's books and records.
4. Presentation and disclosures relating to sales are properly described, sorted, and classified.

These control objectives are similar to management's financial statement assertions that were discussed in the preceding two chapters (see, e.g., Figure 5.1). This is obviously the case because the overall objective of internal control over external financial reporting is to prepare financial statements in accordance with generally accepted accounting principles. However, there is one major difference between control objectives and assertions. The control objectives are broader in that they relate not only to financial reporting but also to operations and compliance.

Which **controls** are most relevant to the audit of financial statements? Generally, the controls that are relevant to an audit are those that pertain to the reliability of financial reporting—that is, those that affect the preparation of financial information for external

reporting purposes. However, other controls may be relevant if they affect the reliability of data that the auditors use to perform auditing procedures. For example, controls applicable to nonfinancial data (e.g., production statistics) that the auditors use in performing analytical procedures may be relevant to an audit.

Controls designed to safeguard the organization's assets are relevant to an audit if they affect the reliability of financial reporting. For example, controls that limit access to the company's inventories may be relevant to a financial statement audit, while controls to prevent the excess use of materials in production generally are not. As long as the financial statements reflect the cost of the materials used, the auditors are not directly concerned with the inefficiencies of production.

The Foreign Corrupt Practices Act of 1977



The importance of establishing and maintaining effective internal control is also illustrated by the passage of the **Foreign Corrupt Practices Act**. In the mid-1970s, hundreds of American corporations acknowledged having made payments (bribes and kickbacks) to officials in foreign countries to obtain business. In many cases, the payments were legal under the laws of the countries in which they were made, but they were not in accordance with American standards of business ethics. In some instances, these questionable payments were made without the authorization or knowledge of the top executives of the corporations involved. By passing the Foreign Corrupt Practices Act of 1977, Congress ordered an end to these practices. Payments to foreign officials for the purpose of securing business are specifically prohibited for *all American businesses* by the anti-bribery provisions of the act. To prevent top management from asserting that they were not aware of the payments, internal control provisions also were included in the act. The internal control provisions require *all corporations under the jurisdiction of the SEC* (regardless of whether the corporation has international operations) to maintain a system of internal control that will provide reasonable assurance that

1. Transactions are executed with the knowledge and authorization of management.
2. Transactions are recorded as necessary to permit the preparation of reliable financial statements and maintain accountability for assets.
3. Access to assets is limited to authorized individuals.
4. Accounting records of assets are compared to existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

Violations of either the anti-bribery or internal control provisions of the Act can result in fines and imprisonment of the members of management who are responsible. Thus, an effective system of internal control, long viewed as essential to the operation of a large organization, is required by federal law.

Means of Achieving Internal Control

Internal control varies significantly from one organization to the next, depending on such factors as organization size, nature of operations, and objectives. Yet certain features are essential to satisfactory internal control in almost any organization. In all systems, a variety of controls must be designed to accomplish the control objectives. Controls over financial reporting are often classified as preventive, detective, or corrective.

Preventive controls are aimed at avoiding the occurrence of misstatements in the financial statements. Examples of preventive controls include segregation of duties and requiring approval of period-ending journal entries. **Detective controls** are designed to discover misstatements after they have occurred. A policy requiring the preparation of monthly bank reconciliations is an example of a control that could detect misstatements of cash receipts or disbursements. When detective controls discover a misstatement, a **corrective control** is ordinarily needed to remedy the situation. Maintaining backup copies of key transactions and master files to allow the correction of data entry errors is a common example of a corrective control. It is important to realize that preventive controls often operate at the individual transaction level, while detective controls may operate at the transaction level or at a higher level.

Controls differ in the size of misstatement it will prevent or detect if it is operating effectively—this is referred to as a control’s precision. As an example, a carefully prepared bank reconciliation may function at an extremely precise level relating to certain aspects of cash, whereas a supervisor simply scanning a bank statement at the end of a quarter for reasonableness may be very imprecise. Various controls are often designed to overlap one another to address the imprecision and other control limitations.

Controls may be **complementary** in that they function together to achieve the same control objective. To illustrate, consider the control that requires all cash disbursements to be authorized and the complementary control of requiring reconciliations of bank statements. These controls work together to help ensure that unauthorized transactions are prevented or detected. Controls are referred to as **redundant** if they address the same financial statement assertion or control objective. Finally, a **compensating control** reduces the risk that an existing or potential control weakness will result in a misstatement. As an example, a small business may not have enough personnel to allow for the adequate segregation of duties, but the owner-manager of the business may carefully review accounting records and reports to compensate for the weakness.

Controls within a system of internal control may be categorized as being either direct or indirect. A **direct control** is specifically designed and precise enough to prevent or detect on a timely basis a material misstatement of a particular assertion relating to a significant account, transaction or disclosure. An **indirect control** is a control that is not precise enough to detect material misstatements at the assertion level but instead may have an indirect effect on the detection of material misstatements. To illustrate, reconciliation of a company’s bank account, a direct control, may identify a variety of misstatements of cash with a high level of precision. An active audit committee, while supportive of such direct controls, is an indirect control that, in and of itself, is unlikely to identify a misstatement of a particular assertion due to its imprecision.

Components of Internal Control

LO 7-2

Describe the major components of a client’s internal control, explain the major limitations of internal control, and distinguish internal control from enterprise risk management.

The Committee of Sponsoring Organizations report developed five components of internal control, which it saw as a suitable way for organizing the internal control of all organizations:

1. The control environment.
2. The risk assessment process.
3. Control activities.
4. Information and communication (we will refer to this as the accounting information system).
5. The monitoring activities.

The components have been widely accepted by companies in the United States as well as in many other countries. PCAOB, AICPA, and international auditing standards relating to internal control are all structured using these components. We discuss the components in the following sections. In considering the components, it is helpful to know that while each of the five ordinarily includes a combination of direct and indirect controls, the control environment, risk assessment process, and monitoring activities components (1, 2, and 5 above) are primarily composed of indirect controls, while the control activities and the accounting information system components (3 and 4) primarily include direct controls.

The Control Environment

The control environment may be viewed as the foundation for the other internal control components; it is defined by the standards, processes, and structures that guide individuals in carrying out their duties. The basic principles of the control environment include

- Commitment to integrity and ethical values.
- Board of directors that demonstrates independence from management and exercises effective oversight of internal control.

- Establishment of effective structure, including reporting lines, and appropriate authorities and responsibilities.
- Commitment to attract, develop, and retain competent employees.
- Holding employees accountable for internal control responsibilities.



Commitment to Integrity and Ethical Values

The effectiveness of internal control depends directly upon a commitment to integrity and ethical values by the board of directors and senior management. Senior management and the board of directors are expected to lead by example in establishing values and expectations regarding appropriate behavior. When this is done well, the organization is said to have a strong tone at the top. This commitment to integrity and ethical values is communicated through the organization's standards of conduct and emphasized through directives, actions, and behavior. Many organizations require their personnel to engage in periodic training on the code of conduct and to certify that they are and have been in compliance. An organization should also establish processes to enforce standards of conduct, ensuring that deviations are identified and remedied on a timely and consistent basis. If management outsources significant activities, assurance should be obtained through communication and oversight that the provider of the outsourced activities adheres to the organization's standard of conduct.

Effective Board of Directors

The board of directors and its audit committee should demonstrate independence from management and properly oversee the development and performance of the organization's internal control. Factors considered here are the skills, expertise, and stature of the board's members, the extent to which the board raises and pursues difficult questions with management, and its interaction with the internal and external auditors. For SEC registrants, the Sarbanes-Oxley Act of 2002 requires the audit committee to be directly responsible for the appointment, compensation, and oversight of the work of the CPA firm (including resolution of any disagreements between management and the CPA firm).

As described in Chapter 6, the audit committee should be composed of independent directors who are not officers or employees of the organization and who do not have other relationships that impair their independence. This is meant to help enable the audit committee to be effective at overseeing the quality of the organization's financial reports and internal control and acting as a deterrent to management override of controls and management fraud. In addition, the audit committee should have one or more members who have financial reporting expertise.

Other committees of the board of directors are also important to an effective control environment. The compensation committee oversees the policies and procedures for management compensation to help ensure that it is aligned with the strategic objectives and risk appetite of the organization. The nomination and governance committees lead the selection of competent directors and oversee the evaluation of the board members and senior management.

Effective Organizational Structure

Management should establish, with board of director oversight, an effective **organizational structure** to properly separate authority, reporting lines, and responsibilities of the various positions within the organization. A well-designed organizational structure provides a basis for planning, directing, and controlling operations. It divides authority, responsibilities, and duties among members of an organization by dealing with such issues as centralized versus decentralized decision making and appropriate segregation of duties among the various departments.

When management decision making is centralized and dominated by one individual, that individual's abilities and moral character are extremely important to the auditors. When operations are decentralized, procedures to monitor the decision making of the many managers involved become equally important.

Personnel within an organization need to have a clear understanding of their responsibilities and the rules and regulations that govern their actions. Therefore, to enhance

the control environment, management develops employee job descriptions and clearly defines authority and responsibility within the organization. Policies also may be established describing appropriate business practices, knowledge and experience of key personnel, and the use of resources.

The organizational structure of an entity should separate responsibilities for (1) *authorization* of transactions, (2) *record keeping* for transactions, and (3) *custody* of assets. In addition, to the extent practical, execution of the transaction should be segregated from these other responsibilities. The effectiveness of such structure is usually obtained by having designated department heads who are evaluated on the basis of the performance of their respective departments. The top executives of the major departments should be of equal rank and should report directly to the president or to an executive vice president. The partial organization chart in Figure 7.1 illustrates such an arrangement. If, for example, the controller were a line subordinate to the vice president of production, the organizational independence of the accounting department would be greatly impaired.

Responsibilities of Finance and Accounting Departments

Finance and accounting are the two departments most directly involved in the financial affairs of a business enterprise. The division of responsibilities between these departments illustrates the separation of the accounting function from operations and also from the custody of assets. Under the direction of the *treasurer*, the finance department is responsible for financial operations and custody of liquid assets. Activities of this department include planning future cash requirements, establishing customer credit policies, and arranging to meet the short- and long-term financing needs of the business. In addition, the finance department has custody of bank accounts and other liquid assets, invests idle cash, handles cash receipts, and makes cash disbursements. In short, it is the finance department that conducts financial activities.

The accounting department, under the authority of the *controller*, is responsible for all accounting functions and, often, the design and implementation of internal control. With respect to financial activity, the accounting department records financial transactions but does not handle financial assets. Accounting records establish accountability over assets and provide the information necessary for financial reports, tax returns, and daily operating decisions. With respect to internal control, the accounting department maintains the independent records with which quantities of assets and operating results are compared. Often, this reconciliation function is performed by the *operations control group* or some other subdepartment within accounting.

Many of the subdepartments often found within accounting are illustrated in Figure 7.1. It is important for many of these subdepartments to be relatively independent of one another. For example, if the operations control group reconciles assets on hand to the accounting records, it is essential that the operations control personnel not maintain those records.

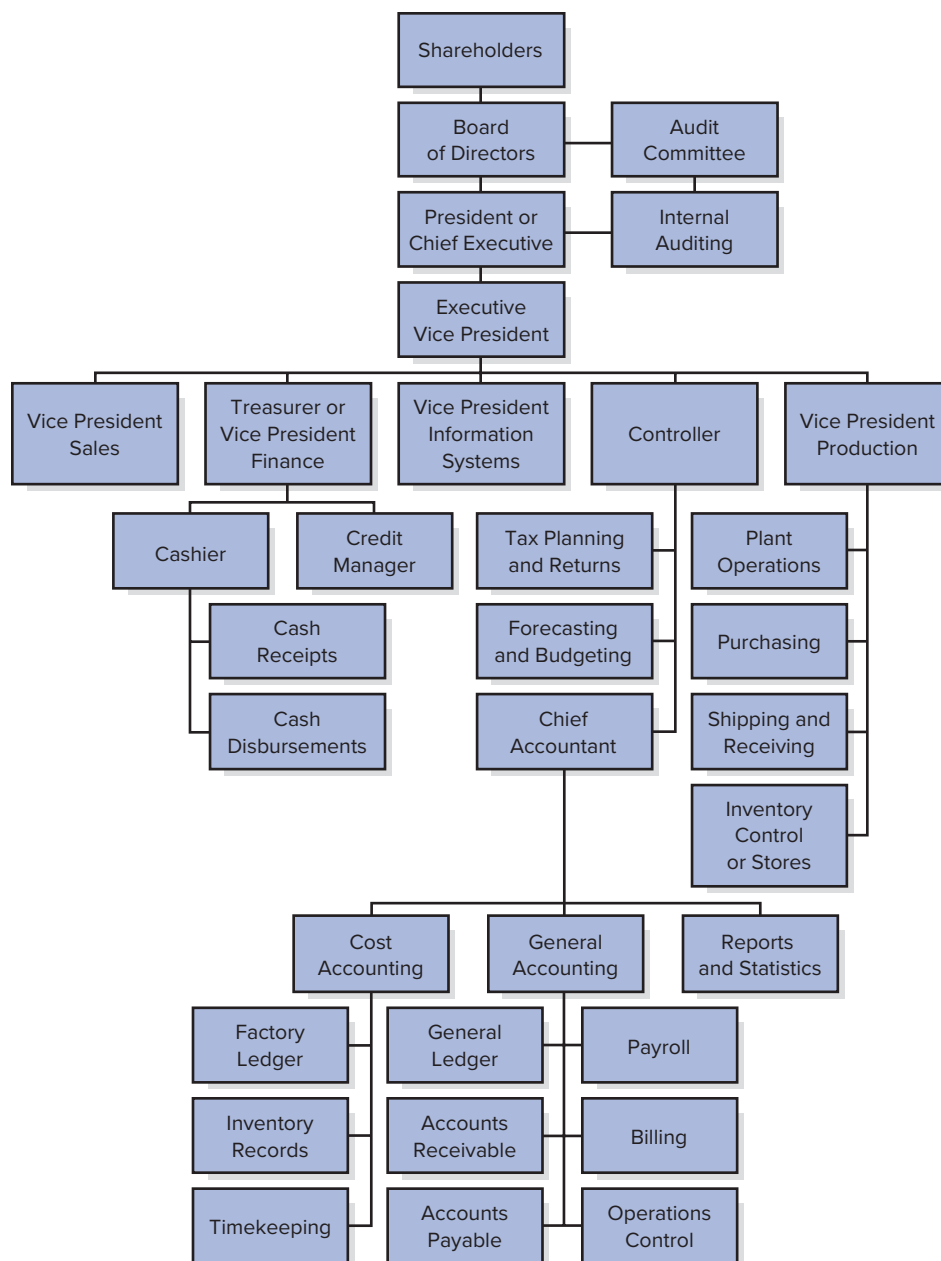
Attracting, Developing, and Retaining Competent Employees

Ultimately, the effectiveness of internal control is affected by the characteristics of the organization's personnel. Thus, management's policies and practices for hiring, developing, and retaining competent employees has a significant effect on the effectiveness of the control environment. As an example, standards for hiring the most qualified individuals with an emphasis on education, experience, and evidence of integrity and ethical behavior illustrate the organization's commitment to hiring competent and trustworthy people. The organization should invest sufficiently in development and training of all personnel. Effective human resource policies often can mitigate other weaknesses in the control environment.

Individual Accountability

The organization must hold individuals accountable for their internal control responsibilities to assure the effectiveness of the process. Ultimately, it is the board of directors that should hold the chief executive officer accountable for internal control in the achievement of the company's objectives. Expectations should be made clear to employees and deviations from internal controls should be thoroughly investigated.

FIGURE 7.1
Partial Organization
Chart



Risk Assessment

Organizations ordinarily face a variety of risks from external and internal sources that threaten their ability to meet their objectives in the areas of operations, reporting, and compliance. Risk assessment is management's process for identifying, analyzing, and responding to such risks. In performing effective risk assessment, organizations should

- Clearly specify objectives to allow the identification and assessment of risks related to those objectives.
- Identify and analyze risks to the achievement of its objectives to determine how they may be managed.
- Consider potential fraud relating to the achievement of objectives.
- Identify and assess changes that could impact internal control.

In Chapters 5 and 6, we described the auditor's risk assessment in a financial statement audit. How does the auditors' risk assessment differ from management's risk assessment?



Illustrative Case

Importance of Organizational Structure

During the audit of a nonpublic company, the auditors' study of organizational lines of authority and their use of an internal control questionnaire disclosed that the receiving department personnel were under the direction of the purchasing agent. Accounts payable department employees had also been instructed to accept informal memoranda from the purchasing agent as evidence of receipt of merchandise and propriety of invoices.

Because of this deficiency in internal control, the auditors thoroughly examined purchase invoices and came across a

number of large December invoices from one supplier bearing the notation "Subject to adjustment at time of delivery of merchandise." Investigation of these transactions disclosed that the merchandise had not yet been delivered, but the invoices had been paid. The purchasing agent explained that he had requested the advance billing in an effort to reduce taxable income for the year under audit, during which profits had been higher than usual. Further investigation revealed that the purchasing agent held a substantial personal interest in the suppliers making the advance billings and that top management was not aware of this conflict of interest.

Although there are similarities, the auditors' risk assessment is primarily concerned with evaluating the likelihood of material misstatements in the financial statements. While this can encompass reporting, operations, and compliance, the scope of management's risk analysis in the areas of operations, compliance, and internal reporting is much broader.

Effective risk management requires the establishment of performance measures to assess the achievement of objectives. This allows management to establish risk tolerance for its various objectives, and manage these risks. **Risk tolerance** is the organization's acceptable level of variation in performance relative to the achievement of objectives. Risks may exist at the entity level or the transaction level. Entity-level risks arise from external or internal factors, such as economic, regulatory, technology, and personnel factors. Transaction-level risks are found within divisions, operating units, or functions of the organization. Such risks generally relate directly to the financial statement assertions described in Chapter 6.

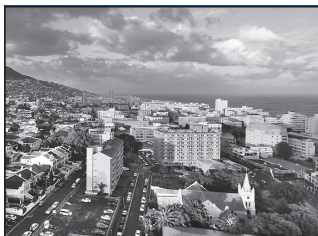
Assessing risk involves evaluating the *likelihood of occurrence and the magnitude of the potential impact*. It also involves consideration of the *velocity or speed of occurrence and duration of impact* of the risk. This assessment allows management to identify the significant risks of the organization that require a response. Risk responses fall in the following major categories:

- *Avoidance*. This response involves exiting the activity that gives rise to the risk.
- *Reduction*. This response involves taking action to reduce risk likelihood or impact, or both. For example, risk reduction might involve managing the risk or adding additional controls to processes.
- *Sharing*. This response involves reducing risk likelihood or impact by transferring or sharing a portion of the risk. Techniques for sharing include insurance, hedging, and outsourcing.
- *Acceptance*. This response involves taking no action because the risk is consistent with the risk tolerance of the organization.

Control Activities

Control activities are policies and procedures that management implements to help mitigate the risk that the organization's objectives are not met. The basic principles are that management should

- Select and develop control activities that mitigate risks of the achievement of organization objectives to acceptable levels.
- Select and develop general control activities over technology to support organization objectives.
- Deploy control activities through policies that establish what is expected and procedures that put those policies into action.



Illustrative Case

Importance of Segregation of Custody and Record Keeping

A manufacturer of golf clubs operated a large storeroom containing thousands of sets of golf clubs ready for shipment. Detailed perpetual inventory records were maintained by the employee in charge of the storeroom. A shortage of several sets of clubs developed as a result of theft by another employee who had acquired an unauthorized key to the storeroom. The employee responsible for the storeroom discovered the discrepancy between

the clubs in stock and the quantities of clubs as shown by the records. Fearing criticism of his record keeping, he changed the inventory records to agree with the quantities on hand. The thefts continued, and large losses were sustained before the shortages were discovered. If the inventory records had been maintained by someone not responsible for physical custody of the merchandise, there would have been no incentive to conceal shortages by falsifying the records.

While there are many different types of control activities performed in an organization, the following types are generally relevant to an audit of the organization's financial statements: performance reviews, transaction control activities, physical controls, and segregation of duties.

Performance Reviews

These controls include reviews of actual performance as compared to budgets, forecasts, and prior-period performance; relating different sets of data to one another; and performing overall reviews of performance. Performance reviews provide management with an overall indication of whether personnel at various levels are effectively pursuing the objectives of the organization. By investigating the reasons for unexpected performance, management may make timely changes in strategies and plans or take other appropriate corrective action.

Transaction Control Activities

A variety of control activities are performed to check the accuracy, completeness, validity, and authorization of transactions. The major types include authorizations and approvals, verifications, physical controls, controls over standing data, reconciliations, and supervisory controls.

An important aspect of transaction processing controls is the proper authorization of all types of transactions. Authorization of transactions may be either general or specific. *General authorization* occurs when management establishes criteria for acceptance of a certain type of transaction. For example, top management may establish general price lists and credit policies for new customers. Transactions with customers that meet these criteria can then be approved by the sales and credit departments. *Specific authorization* occurs when transactions are authorized on an individual basis. For example, top management may consider individually and authorize specifically any sales transaction in excess of a specified amount, say, \$100,000.

Another control over transaction processing is a system of well-designed forms and documents. To illustrate, consider the processing of a credit sales transaction. The accounting department receives internal documents (in paper or electronic form) prepared by the sales, credit, and shipping departments to properly record the transaction. The documents inform the accounting department that the sale was authorized and approved and goods were shipped to the customer.

A control of wide applicability is the use of serial numbers on documents. Serial numbers provide control over the number of documents issued. Checks, tickets, sales invoices, purchase orders, stock certificates, and many other business papers can be controlled in this manner. For some documents, such as checks, it may be desirable to account for the sequence used by a monthly or weekly inspection of the documents issued. For other documents, as in the case of serially numbered admission tickets, control may be

achieved by noting the last serial number issued each day, and thereby computing the total value of tickets issued during the day. In computerized accounting systems, the computer assigns numbers to the transactions and documents and ensures that all transactions are processed.

General Controls and Application Controls

Transaction-level controls may be broken into two categories: general control activities that apply to all or multiple types of transactions and application controls that apply to the processing of a single type of transaction. To illustrate, controls that restrict access to technology to only authorized users provide *general control* over technology, helping to ensure the reliability of all types of transactions. Controls over the authorization and processing of payroll transactions are *application controls* that only affect the reliability of payroll transactions. Chapter 8 provides a description of general controls and application control activities in an information technology environment.

Physical Controls

Physical controls include those that provide physical security over both records and other assets. Activities that safeguard records may include maintaining control at all times over unissued prenumbered documents, as well as other journals and ledgers, and restricting access to computer programs and data files.

Only authorized individuals should be allowed access to the company's valuable assets. Direct physical access to assets may be controlled through the use of safes, locks, fences, and guards. As a very simple example, companies use security systems to stop the theft of inventory. Also, any negotiable financial instruments are held by the organization's financial institution or locked in a safe.

Improper indirect access to assets, generally accomplished by falsifying financial records, also must be prevented. This may be accomplished by safeguarding the financial records, as described above.

Periodic reconciliations should be made between accounting records and the physical assets on hand. Investigation of the cause of any discrepancies will uncover weaknesses either in procedures for safeguarding assets or in maintaining the related accounting records. Without these comparisons, waste, loss, or theft of the related assets may go undetected.

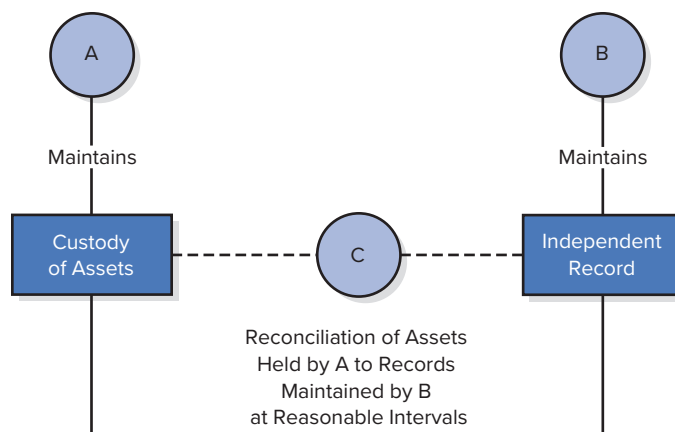
Figure 7.2 illustrates the use of an independently maintained record to establish accountability for assets. It is *not* essential that all three parties in the diagram (A, B, and C) be employees of the company; one or more may be an outside party or a computer device. For example, if A is a bank with custody of cash on deposit, B would be the company employees maintaining records of cash receipts and disbursements, and C might be a computer program that performs periodic bank reconciliations. Or if A is a salesclerk with custody of cash receipts from sales, B could be a sales terminal that maintains an independent record of sales, and C could be the departmental supervisor. Regardless of the nature of the parties involved, the principle remains the same: Accounting records should be maintained independently of custody of the related assets and should be reconciled at reasonable intervals to asset quantities on hand.

Management also should establish *supervisory controls* that assess whether other transaction control activities are operating properly. Usually supervisory controls are focused on high-risk transactions.

Segregation of Duties

A fundamental concept of internal control is that no one department or person should handle all aspects of a transaction from beginning to end. We have already discussed the segregation of responsibilities among departments. In a similar manner, no one individual should perform more than one of the functions of *authorizing* transactions, *recording* transactions, and *maintaining custody* over assets. Also, to the extent possible, individuals executing the specific transaction should be segregated from these functions. The goal

FIGURE 7.2
Establishing
Accountability for Assets



is to not allow individuals to have **incompatible duties** that would allow them to both perpetrate and conceal errors or fraud in the normal course of their duties.

A credit sales transaction may be used to illustrate appropriate authorization and segregation procedures. Top management may have generally authorized the sale of merchandise at specified credit terms to customers who meet certain requirements. The credit department may approve the sales transactions by ascertaining that the extension of credit and the terms of sale are in compliance with company policies. Once the sale is approved, the shipping department executes the transaction by obtaining custody of the merchandise from the inventory stores department and shipping it to the customer. The accounting department uses the documentation created by the sales, credit, and shipping departments as a basis for recording the transaction and billing the customer. With this segregation of duties, no one department or individual can initiate and execute an unauthorized transaction.

Controls over Accounting Estimates

Financial statements include a number of significant accounting estimates, including estimates of fair values of assets and liabilities. Controls over these estimates are particularly important because the development of them often requires significant judgment. Controls that should be established for accounting estimates include the following:

1. Control environment policies and procedures that encourage proper estimates.
2. Risk assessment—including consideration of the risks that inaccurate accounting estimates may result in the issuance of misstated financial statements—and appropriate responses to these risks.
3. Policies that ensure that qualified personnel are involved in developing the estimates.
4. Policies and procedures that ensure that relevant, sufficient, and reliable data are considered in the development of the estimates and that the model used can produce estimates consistent with the financial reporting framework (e.g., generally accepted accounting principles).
5. Management review of sources of data, processes used to develop the assumptions, changes in the methods used, and the reasonableness of assumptions and estimates.
6. Policies to ensure use of the work of specialists when considered necessary.
7. Policies to improve estimation processes by comparison of prior estimates with subsequent results.

Fidelity Bonds

Control activities are not a guarantee against losses from dishonest employees. It is often the most trusted employees who engineer large embezzlements. That they are so highly

trusted explains why they have access to cash, securities, and company records and are in a position that makes embezzlement possible.

Many organizations purchase fidelity bonds to cover employees handling cash or other negotiable assets. **Fidelity bonds** are a form of insurance in which a bonding company agrees to reimburse an employer, within limits, for losses attributable to theft or embezzlement by bonded employees. Companies with only a few employees at risk may obtain individual fidelity bonds; larger concerns may prefer to obtain a blanket fidelity bond covering a number of employees. Before issuing fidelity bonds, underwriters investigate thoroughly the past records of the employees to be bonded. This service offers added protection by preventing the employment of persons with dubious records in positions of trust. Bonding companies are much more likely to prosecute fraud cases vigorously than are employers; general awareness of this fact is another deterrent against dishonesty on the part of bonded employees.

The Accounting Information System²

Information is needed at all levels of an organization to assist management in meeting the organization's objectives. In this area, management

- Obtains and uses relevant, quality information to support the functioning of other internal control components.
- Communicates internally the information necessary to support the functioning of other components of internal control.
- Communicates with external parties regarding matters affecting the functioning of other components of internal control.

An organization's accounting information system consists of the methods and records established to initiate, authorize, record, process, summarize, and report an entity's transactions and to maintain accountability for the related assets, liabilities, and equity. Accordingly, an accounting information system should

1. Identify and record all valid transactions.
2. Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
3. Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
4. Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
5. Present properly the transactions and related disclosures in the financial statements.

In addition to the typical system of journals, ledgers, and other record-keeping devices, an *accounting information system* should include a chart of accounts and a manual of accounting policies and procedures as aids for communicating policies and procedures. A *chart of accounts* is a classified listing of all accounts in use, accompanied by a detailed description of the purpose and content of each. A *manual of accounting policies and procedures* states clearly in writing the methods of treating transactions. In combination, the chart of accounts and manual of accounting policies and procedures should provide clear guidance that will allow proper and uniform handling of transactions and events.

Proper communication involves providing employees with an understanding of their individual roles and responsibilities relating to financial reporting. Open communication channels are essential to proper functioning of an information system. Personnel that process information should understand how their activities relate to the work of others and the importance of reporting exceptions and other unusual items to an appropriate level of management.

² *Internal Control—Integrated Framework* refers to this component as information and communication. However, the accounting information system is of primary importance to an audit of financial statements.

Monitoring of Controls

Monitoring of controls, the last component of internal control, is a process to assess the quality of internal control performance over time. The basic principles are that the organization should

- Select, develop, and perform ongoing and separate monitoring evaluations to determine that the components of internal control are present and functioning.
- Evaluate and communicate internal control deficiencies in a timely manner to those responsible for taking corrective action, including senior management and the board of directors and its audit committee as appropriate.

The first bullet above mentions ongoing and separate monitoring evaluations. *Ongoing monitoring evaluations* include regularly performed supervisory and management activities, such as monitoring of customer complaints or reviewing the reasonableness of management reports. Increasingly, automated tools and technologies are being used to continuously monitor processes for errors and unusual items that might be indicative of a breakdown in other internal controls. *Separate evaluations* are monitoring activities that are performed on a nonroutine basis, such as periodic audits by the internal auditors.

Management Review Controls

Management review controls are those that operate through management review of information for evidence of errors, fraud, or breakdowns in other controls. Documents reviewed often include various reconciliations, journal entries, and budget-to-actual variances. For example, management may review such documents for unusual and unexpected items such as on a monthly or quarterly basis reviewing (1) recorded revenues in relation to forecasted revenues and (2) gross profit margins and expenses as a percentage of sales. Such controls may also involve reviewing calculations related to accounting estimates or monitoring controls that involve management review of the results of operations. With the advent of big data, management is increasingly using data analytics to identify unusual items or relationships. Data analytics allows management to review and test all transactions with amazing efficiency. It is important that such reviews are adequately documented and sensitive enough to detect material misstatements.

Internal Audit Function

An important aspect of the organization's monitoring system is the internal audit function. Internal auditors investigate and appraise internal control and the efficiency with which the various units of the organization are performing their assigned functions, and they report their findings and recommendations to management and the audit committee. As representatives of top management, internal auditors are interested in determining whether each branch or department has a clear understanding of its assignment; is adequately staffed; maintains good records; properly safeguards cash, inventories, and other assets; and cooperates harmoniously with other departments. In addition, internal auditors monitor management and help prevent management override of internal control. The manner in which the CPAs use the work of internal auditors is discussed later in this chapter; the internal auditing profession is discussed in detail in Chapter 21.

Limitations of Internal Control

Internal control can do much to protect against both errors and fraud and to ensure the organization's objectives are achieved. Still, it is important to recognize the existence of inherent limitations of internal control. Custom, culture, and the corporate governance system may inhibit fraud, but they are not absolute deterrents. Mistakes may be made in the performance of controls as a result of a misunderstanding of instructions, mistakes of judgment, carelessness, distraction, or fatigue. Errors in judgment also may occur in designing, maintaining, or monitoring controls. Control activities—whether manual or automated—dependent upon separation of duties may be circumvented by collusion among two or more people. In addition, unscrupulous management may override internal



Illustrative Case

Management Override



Management override is often as simple as posting improper adjusting journal entries to modify financial results. In a complaint filed by the Securities and Exchange Commission against WorldCom Inc., the SEC accused senior management of disguising the true performance of the company by using undisclosed and improper accounting that overstated income by capitalizing various

costs that should have been treated as expenses. *The New York Times* reported that the company's ex-controller admitted to investigators that he was aware of the expense shifts but that financial pressures being faced by the company left him with little choice. The ability of management to override internal control is difficult to prevent. Companies must rely upon active participation by the audit committee and an effective internal audit department.

control. Management, for example, may enter into side agreements with customers that alter the terms and conditions of the company's standard contract in ways that alter when and how revenue should be recognized. Also, management may modify the accounting records in a variety of improper manners.

The extent of the controls adopted by a business also is limited by cost considerations. It is not feasible from a cost standpoint to establish controls that provide absolute protection from errors, fraud, and waste; reasonable assurance in this regard is generally the best that can be achieved.

Enterprise Risk Management

Organizations often establish an enterprise risk management system as an integral part of corporate strategy and execution in creating and maintaining corporate value. In 2004, the Committee of Sponsoring Organizations (COSO) issued an entity risk management framework to assist organizations in creating such a system. Subsequently, in 2017, that framework was updated through issuance of COSO's *Enterprise Risk Management: Aligning Risk with Strategy and Performance*.

As discussed earlier in this chapter, COSO established the internal control framework used by auditors and most public companies. The internal control and enterprise risk management (ERM) frameworks are meant to complement one another, with the latter including but focusing beyond internal control in managing risks.

When an organization integrates enterprise risk management throughout its operations, it may be able to improve decision making in areas such as governance, strategy, objective-setting, and day-to-day operations. Potential benefits include

- Aligning the organization's risk tolerance, strategy, and operations.
- Identifying and managing both single and multiple risks and entity-wide and lower-level risks.
- Reducing operational surprises and losses.
- Reducing performance variability.
- Identifying opportunities.
- Improving the deployment of capital.

The 2017 enterprise risk management framework has the following five components:

1. **Governance and culture.** Governance and culture together form a basis for all other components of enterprise risk management. Governance sets the entity's tone, reinforcing the importance of enterprise risk management and establishing oversight responsibilities for it. Culture is reflected in decision making.

2. **Strategy and objective-setting.** Enterprise risk management is integrated into the entity's strategic plan through the process of setting strategy and business objectives. With an understanding of business context, the organization can gain insight into internal and external factors and their effect on risk. An organization sets its risk appetite in conjunction with strategy-setting. The business objectives allow strategy to be put into practice and shape the entity's day-to-day operations and priorities.
3. **Performance.** An organization identifies and assesses risks that may affect an entity's ability to achieve its strategy and business objectives. As part of that pursuit, the organization identifies and assesses risks that may affect the achievement of that strategy and business objectives. It prioritizes risks according to their severity and considering the entity's risk appetite. The organization then selects risk responses and monitors performance for change. In this way, it develops a portfolio view of the amount of risk the entity has assumed in the pursuit of its strategy and entity-level business objectives.
4. **Review and revision.** By reviewing enterprise risk management capabilities and practices, and the entity's performance relative to its targets, an organization can consider how well the enterprise risk management capabilities and practices have increased value over time and will continue to drive value in light of substantial changes.
5. **Information, communication, and reporting.** Communication is the continual, iterative process of obtaining information and sharing it throughout the entity. Management uses relevant information from both internal and external sources to support enterprise risk management. The organization leverages information systems to capture, process, and manage data and information. By using information that applies to all components, the organization reports on risk, culture, and performance.

It is not necessary for an organization to implement an enterprise risk management system that meets these criteria in order to have effective internal control or risk management. However, the criteria do provide a management of organizations with an organized approach for implementing systems for managing risks. For many organizations this may result in better management of business risks.

Corporate Governance and Its Relationship to Internal Control

As described in Chapter 1, corporate governance is the set of rules, processes, and laws by which businesses are operated, regulated, and controlled. It includes the policies, procedures, and mechanism that are established to ensure that the company operates in the best interests of its major stakeholders, including owners, customers, suppliers, employees, and society as a whole. For a corporation, the major instruments of corporate governance include management compensation systems, the boards of directors (including major committees), external (independent) auditors, internal auditors, attorneys, regulators, creditors, securities analysts, and internal control systems.

The concept of corporate governance is somewhat broader than internal control in that it not only is concerned with the effectiveness of financial reporting, but it also encompasses ethical treatment of all major stakeholders, compliance with laws, regulations, customary business practices, and effective risk management. Because management plays the major role in determining how various stakeholders are treated, corporate governance is primarily concerned with controlling management and providing incentives for appropriate management behavior.

From an internal standpoint, the control environment is particularly significant to corporate governance. It is important that the board exercises an independent oversight of management, including taking a major role in risk management of the corporation. In particular, the audit committee of the board should provide effective oversight of management. The compensation committee should assure that management is compensated in a manner that does not provide management with incentives to engage in inappropriate behavior. An independent internal audit function is also a significant internal mechanism for corporate governance.



Illustrative Case

Risk Management and Corporate Governance

The MF Global case clearly illustrates the importance of the risk management aspect of corporate governance. MF Global was a multinational futures broker and bond dealer. Jon Corzine (former senator, New Jersey governor, and CEO of Goldman Sachs) was appointed CEO and chairman of MF Global. Under his leadership, the firm undertook a risky investment strategy, including huge bets on the sovereign debt of European countries with fiscal problems. As the amounts invested in these risky instruments increased, the then–chief risk officer (CRO) made a series of presentations to

the board of directors describing the risks related to the investment strategy. Corzine and the board of directors concluded that the potential risks presented by the CRO were implausible. Shortly thereafter, the CRO was replaced by another CRO, who appeared to be less concerned about the risks involved in management's investment strategy.

During the following year, the firm announced that it had encountered a significant amount of losses, including the loss of hundreds of millions of investor funds that were supposed to be segregated. Subsequently, MF Global collapsed and filed for bankruptcy.

The major external mechanisms of corporate governance include regulators (such as the SEC), external auditors, creditors, underwriters, securities analysts, and major shareholders.

Financial Statement Audits: The Role of Internal Control

LO 7-3

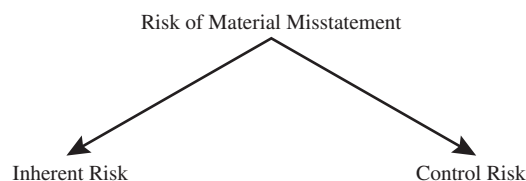
Describe the auditors' consideration of internal control.

Recall from Chapter 6 that the overall approach that auditors use in a financial statement audit includes

1. Plan the audit.
2. Obtain an understanding of the client and its environment, including internal control.
3. Assess the risks of misstatement and design further audit procedures.
4. Perform further audit procedures.
5. Complete the audit.
6. Form an opinion and issue the audit report.

Internal control is most directly related to stages 2 through 4.³

The auditors use **risk assessment procedures** to obtain an understanding of internal control. The understanding obtained, combined with the auditors' other evidence, allows them to assess the risk of material misstatement. Recall that at the assertion level, the risk of misstatement is composed of **inherent risk** and **control risk** as



Results of the risk assessment are used to *design the nature, timing, and extent of further audit procedures*. Recall from Chapters 5 and 6 that **further audit procedures** include **tests of controls** and **substantive procedures**. The design of further audit procedures

³ A terminology issue arises relating to internal control as considered on audits. The PCAOB auditing standards and the COSO framework use the term "internal control," while the AICPA auditing standards and international auditing standards use the term "system of internal control." We consider these two terms as equivalent and will use either, but primarily "internal control."

depends upon the results obtained while obtaining an understanding of internal control and assessing the risks of material misstatement. The auditors make decisions about the proper combination of tests of controls (which allow a lower assessment of control risk) and substantive procedures (which restrict detection risk). The following three sections provide details on how auditors obtain an understanding of internal control, how they assess the risks of material misstatement, and how they design and perform tests of controls.

Obtain an Understanding of the Client and Its Environment, Including Internal Control

As discussed in Chapter 6, the auditors perform risk assessment procedures to obtain an understanding of the client and its environment, including internal control. This understanding provides auditors with information to assess the risks of material misstatement and with information on the types of further audit procedures that should be performed. For example, to perform substantive procedures to verify the existence of accounts receivable, the auditors need to know and understand the nature of the underlying source documents.

In making a judgment about the extent of the understanding of internal control that is necessary, the auditors should realize that the information will subsequently be 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.

As we have discussed in Chapter 6, in addition to audit evidence on internal control, audit evidence is collected on the industry in which the client operates and on its overall environment. Previous-year audit results also may provide relevant information relating to the current audit. Also, while performing risk assessment procedures, auditors may realize the need to obtain additional staff support with specialized skills, such as someone with a specialized understanding of information technology. As an example, a professional with information technology skills may be needed on the audit team due to the complexity of the client's systems.

While obtaining an understanding of internal control, the auditors consider its design and determine that it has been implemented (placed in operation). It is helpful to realize that considering the design of a control and determining that it is implemented represent two different operations. For example, the client may provide a detailed flowchart of the *design* of controls over the payroll function. To determine whether it has been implemented, the auditors ordinarily observe the process and make certain that it seems as described. Yet, at this point, no detailed testing of that function (i.e., tests of controls) will ordinarily have been performed.

The auditors also consider inherent risks, judgments about materiality, and the nature of the client's operations.

Required Auditor Understanding of Internal Control Components

In all audits, the auditors' understanding of internal control should encompass each of the internal control components—the control environment, risk assessment, control activities, the accounting information and communication system, and monitoring.

The Control Environment

The auditors should obtain sufficient knowledge to understand management's attitudes, awareness, and actions concerning the control environment. It is important that the auditors concentrate on the substance of controls, rather than their form. For example, an organization may have, but not enforce, a *code of conduct* prohibiting unethical activities.

The company's antifraud programs are of particular importance to the auditors because the professional standards require that the auditor evaluate whether such programs are



Illustrative Case

The COVID-19 pandemic necessitated changes in operations as more client employees moved to a remote work environment. Such changes resulted

in new risks of errors or fraud. It is essential for the auditors to consider how the client responded to these risks by modifying or revamping controls.

suitably designed and implemented. This includes broad programs designed to prevent, deter, and detect fraud, as well as more specific controls. Appendix 7A provides examples of fraud programs and controls.

Risk Assessment

The auditors should obtain an understanding of the client's process for identifying and responding to business risks. This understanding includes how management identifies these risks, estimates their significance, and decides upon actions to manage them. If the client has implemented an enterprise risk management system, the auditors will obtain an understanding of the processes and controls that are implemented in the system. An understanding of the risk assessment process assists the auditors in identifying risks of material misstatement because many such risks arise as a result of business risks faced by the client.

Factors such as the following might be indicative of increased financial reporting risk for a client:

- Changes in the organization's regulatory or operating environment.
- Changes in personnel.
- New or revamped information systems.
- Rapid growth of the organization.
- Changes in technology affecting production processes or information systems.
- New business models, products, or activities.
- Corporate restructurings.
- Expansion or acquisition of foreign operations.
- Adoption of new accounting principles or changing accounting principles.

It is especially important for the auditors to understand the implications of changes in processes and controls that may affect the reliability of financial reporting. Misstatements due to fraud or errors have often arisen from ineffective implementation of new procedures.

Control Activities

While obtaining an understanding of the other internal control components (the control environment, risk assessment, the accounting information system, and monitoring), auditors generally obtain some knowledge about the client's control activities. For example, while obtaining an understanding of the processing of cash transactions, it is likely that the auditors will discover whether the bank accounts are reconciled.

In auditing control activities (automated or manual), the auditors will particularly address the design and implementation of those that affect the risks of material misstatement, including:

- Controls over journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.
- Controls for which the auditor plans to test operating effectiveness in determining the nature, timing, and extent of substantive procedures.

- Controls that address a risk that is determined to be a significant risk.
- Other controls that will enable the auditor to assess the risks of material misstatement at the assertion level and to design further audit procedures.

Whether it is necessary for the auditors to devote additional attention to obtaining an understanding of the other control activities depends on the circumstances of the engagement.

The auditors may find it necessary to understand and test certain control activities to audit a particular assertion. For example, when auditing a charitable organization that receives significant cash donations, the auditors may be unable to effectively plan the audit for the completeness assertion for cash contributions without understanding and testing controls related to the receipt of cash donations. In other circumstances, the auditors may conclude that it would be too costly to audit a particular assertion using only substantive procedures; the most efficient course of action is to increase their understanding and testing of the client's internal control.

The Accounting Information System

To understand the accounting information system, the auditors should become familiar with

- The classes of transactions that are significant to the financial statements.
- How the incorrect processing of transactions is resolved.
- How the information captures significant nonroutine transactions and accounting estimates.
- The procedures used to prepare financial statements and related disclosures, and how misstatements may occur.
- How financial reporting roles and responsibilities and significant matters relating to financial reporting are communicated.

In obtaining an understanding of the client's accounting information system and the related control activities, auditors generally find it useful to divide the overall system into its major transaction cycles. The term **transaction cycle** refers to the policies and the sequence of procedures for processing a particular type of transaction. For example, the accounting system in a manufacturing business might be subdivided into the following major transaction cycles:

1. *Revenue (or sales and collections) cycle*—including processes, procedures, and policies for obtaining orders from customers, approving credit, shipping merchandise, preparing sales invoices (billing), recording revenue and accounts receivable, and handling and recording cash receipts.
2. *Acquisition (or purchases and disbursements) cycle*—including processes, procedures, and policies for initiating purchases of inventory, other assets, and services; placing purchase orders, inspecting goods upon receipt, and preparing receiving reports; recording liabilities to vendors; authorizing payment; and making and recording cash disbursements.
3. *Conversion (production) cycle*—including processes, procedures, and policies for storing materials, placing materials into production, assigning production costs to inventories, and accounting for the cost of goods sold.
4. *Payroll cycle*—including processes, procedures, and policies for hiring, terminating, and determining pay rates; timekeeping; computing gross payroll, payroll taxes, and amounts withheld from gross pay; maintaining payroll records; and preparing and distributing paychecks.
5. *Financing cycle*—including processes, procedures, and policies for authorizing, executing, and recording transactions involving bank loans, leases, bonds payable, and capital stock.
6. *Investing cycle*—including processes, procedures, and policies for authorizing, executing, and recording transactions involving investments in fixed assets and securities.



Illustrative Case

PCAOB Inspection Results on Management Review Controls



Inadequate auditor consideration of management review controls has annually been one of the leading deficiencies identified in PCAOB inspection reports. These reports have disclosed audit deficiencies related to design or operating effectiveness of management review

controls. Related, the PCAOB points out that CPA firms have placed undue emphasis on testing management review controls in some instances without considering whether these controls adequately addressed the risks of material misstatements (PCAOB Staff Audit Practice Alert 11).

The transaction cycles for a particular company depend upon the nature of the company's business activities. A bank, for example, has no production cycle, but has both a lending cycle and a demand deposits cycle. Also, different auditors may elect to define a given company's transaction cycles in different ways. For example, the sales and collections cycle may alternatively be defined as two separate transaction cycles for (1) the processing and recording of credit sales and (2) the handling and recording of cash receipts. The important point to recognize is that dividing internal control into transaction cycles enables the auditor to focus upon the controls that affect the reliability of assertions about specific accounts in the financial statements.

Monitoring of Controls

Finally, the auditors should obtain a sufficient understanding of the entity's monitoring procedures relating to financial reporting to understand how those procedures are used to detect potential misstatements and initiate actions to address inadequate performance. Earlier in this chapter we mentioned that **management review controls**, performed manually or electronically, are a major type of monitoring control. The auditors evaluate the design effectiveness of management review controls by considering the relevance and precision of the controls. The controls are relevant if they address relevant financial statement assertions, and the precision of review controls is affected by

1. The level of aggregation of the data (e.g., weekly versus monthly).
2. The frequency and consistency with which the review is performed.
3. The predictability of the expectations developed by management.
4. The criteria used to determine when an item or relationship is investigated.

When evaluating monitoring controls, the auditors will also consider how the work of internal auditors contributes to internal control. The auditors' consideration of the work of internal auditors is described later in this chapter.

Use of the COSO Framework

The structuring of auditing standards for internal control around the COSO five components raises a question: How should auditors respond in a situation in which the COSO framework is not implemented by a client? That is, while the COSO framework with its five components is well accepted by many companies, for others it may not necessarily reflect how the company designs, implements, and maintains its system of internal control, or how it may classify any particular component. Management might use an internal control framework with different components and in some instances not use a framework at all. For the purpose of either a public or nonpublic company audit, the auditors may use the framework used by management or may use different terminology or frameworks to describe the various aspects of the client's system of internal control and their effect on the audit. However, the auditors must determine that the concepts included in the five COSO components are addressed.

Areas Difficult to Control

Certain areas, including those that include nonroutine transactions and significant accounting estimates, are particularly difficult for management to control. If potentially significant, those areas require special audit consideration. In terms of the audit risk model, the risk of material misstatement is very high for certain assertions in these areas. These assertions requiring special audit consideration often involve nonroutine transactions or accounting estimates.

As we discussed in Chapter 5, *nonroutine* transactions are those that are unusual, due to either size or nature, and occur relatively infrequently. A variety of risks relating to significant nonroutine transactions arise due to factors such as management or other employee intervention—often manual—to specify the accounting treatment for the transactions. In addition, these transactions may be with related parties. Similarly, many accounting *estimates* are of high risk due to their subjective or complex nature, or the need to make assumptions about the effects of future events. Examples include assets and liabilities valued at fair value and revenue accounts that may require estimates subject to differing interpretation (e.g., sales in which the amount of actual realization is difficult to measure).

When determining whether an identified risk of misstatement is significant, requiring special audit consideration, the auditors consider factors such as the following:

- Complexity of calculations involved.
- Risk of fraud.
- Selection and application of accounting policies.
- Internal and external circumstances giving rise to business risks (e.g., technological change in the industry).
- Recent developments in the industry and economy.

Risk Assessment Procedures for Internal Control

LO 7-4

Discuss the techniques used by auditors to obtain an understanding of internal control.

How do auditors obtain an understanding of a client's internal control? Procedures to obtain audit evidence about the design and implementation of relevant controls may include *inquiring* of entity personnel, *observing* the application of specific controls, *inspecting* documents and reports, and *tracing* transactions through the information system relevant to financial reporting. Auditors ordinarily use one or a combination of these approaches to obtain the needed understanding of internal control. One restriction exists, however, in that inquiry alone is not sufficient to evaluate the design of a control and to determine whether it has been implemented.

In repeat engagements, the auditors will stress areas shown as having questionable controls in prior years. It is imperative, however, that auditors recognize that the pattern of operations is an ever-changing one—controls that were adequate last year may now be ineffective.

Auditors may determine the duties and responsibilities of client personnel by inspecting organization charts and job descriptions and interviewing client personnel. Many clients have procedures manuals and flowcharts describing the approved practices to be followed in all phases of operations. Another excellent source of information is in the reports, working papers, and audit programs of the client's internal auditing staff.

The auditors' understanding of internal control encompasses not only the design of controls, but also whether they have been implemented (placed in operation). Implemented means that the control actually exists and is in use; that is, it does not just exist in theory or on paper.

While obtaining an understanding of internal control, the auditors also may obtain evidence about the *operating effectiveness* of various controls. The distinction between knowing that a control has been implemented and obtaining evidence on its *operating effectiveness* is important. To properly perform a financial statement audit, auditors are required to determine that the major controls have been implemented; they are *not* required to evaluate their operating effectiveness.

If the auditors do not plan to test the operating effectiveness of controls, they should assess control risk at the maximum level for the related assertions. This is because the auditors have no evidence on operating effectiveness of the specific controls that were not tested. Also, since the risk of material misstatement at the assertion level is based on inherent risk and control risk, when no tests of operating effectiveness are performed, the assessment of control risk at the maximum level results in a risk of material misstatement that is the same as the assessment of inherent risk. Finally, note that an assessment of control risk at the maximum level occurs in either of two situations: (1) no tests of controls were performed or (2) an auditor finds controls to be ineffective either through the results of tests of controls or through consideration of other evidence. Tests of controls are discussed in detail later in this chapter.

Documenting the Understanding of Internal Control

As the external auditors obtain a working knowledge of internal control, they should document the information in their working papers. The form and extent of this documentation are affected by the size and complexity of the client, as well as the nature of the client's internal control. The documentation usually takes the form of internal control questionnaires, written narratives, or flowcharts.

Internal Control Questionnaire

A traditional method of describing internal control is to fill in a standardized **internal control questionnaire**. Many public accounting firms have developed their own questionnaires for this purpose. The questionnaire usually contains a separate section for each major transaction cycle, enabling the work of completing the questionnaire to be divided conveniently among several audit staff members.

Most internal control questionnaires are designed so that a “no” answer to a question indicates a weakness in internal control and requires the auditors to identify types of potential misstatements arising therefrom. In addition, questionnaires may provide for a distinction between major and minor control weaknesses, an indication of the sources of information used in answering questions, and explanatory comments regarding control deficiencies. A disadvantage of standardized internal control questionnaires is their lack of flexibility. They often contain many questions that are “not applicable” to specific systems, particularly systems for small companies. Also, the situation in which an internal control strength compensates for a weakness may not be obvious from examining a completed questionnaire. An internal control questionnaire relating to cash receipts is illustrated in Figure 7.3.

An internal control questionnaire is intended as a means for the auditors to document their understanding of internal control. If completion of the questionnaire is regarded as an end in itself, there may be a tendency for the auditors to fill in the “yes” and “no” answers in a mechanical manner, without any real understanding or study of the transaction cycle. For this reason, some public accounting firms prefer to use written narratives or flowcharts in lieu of, or in conjunction with, questionnaires.

Written Narratives of Internal Control

Written narratives of internal control are memoranda that describe the flow of transaction cycles, identifying the employees performing various tasks, the documents prepared, the records maintained, and the division of duties. Figure 7.4 is a written narrative, describing internal control over cash receipts received in the form of checks.

Flowcharts of Internal Control

Many CPA firms consider systems flowcharts to be more effective than questionnaires or narrative descriptions in documenting their understanding of a client's accounting information system and the related control activities. A **systems flowchart** is a diagram—a symbolic representation of a system or a series of procedures with each procedure shown in sequence. To the experienced reader, a flowchart conveys a clear image of the system, showing the nature and sequence of procedures, division of responsibilities, sources and

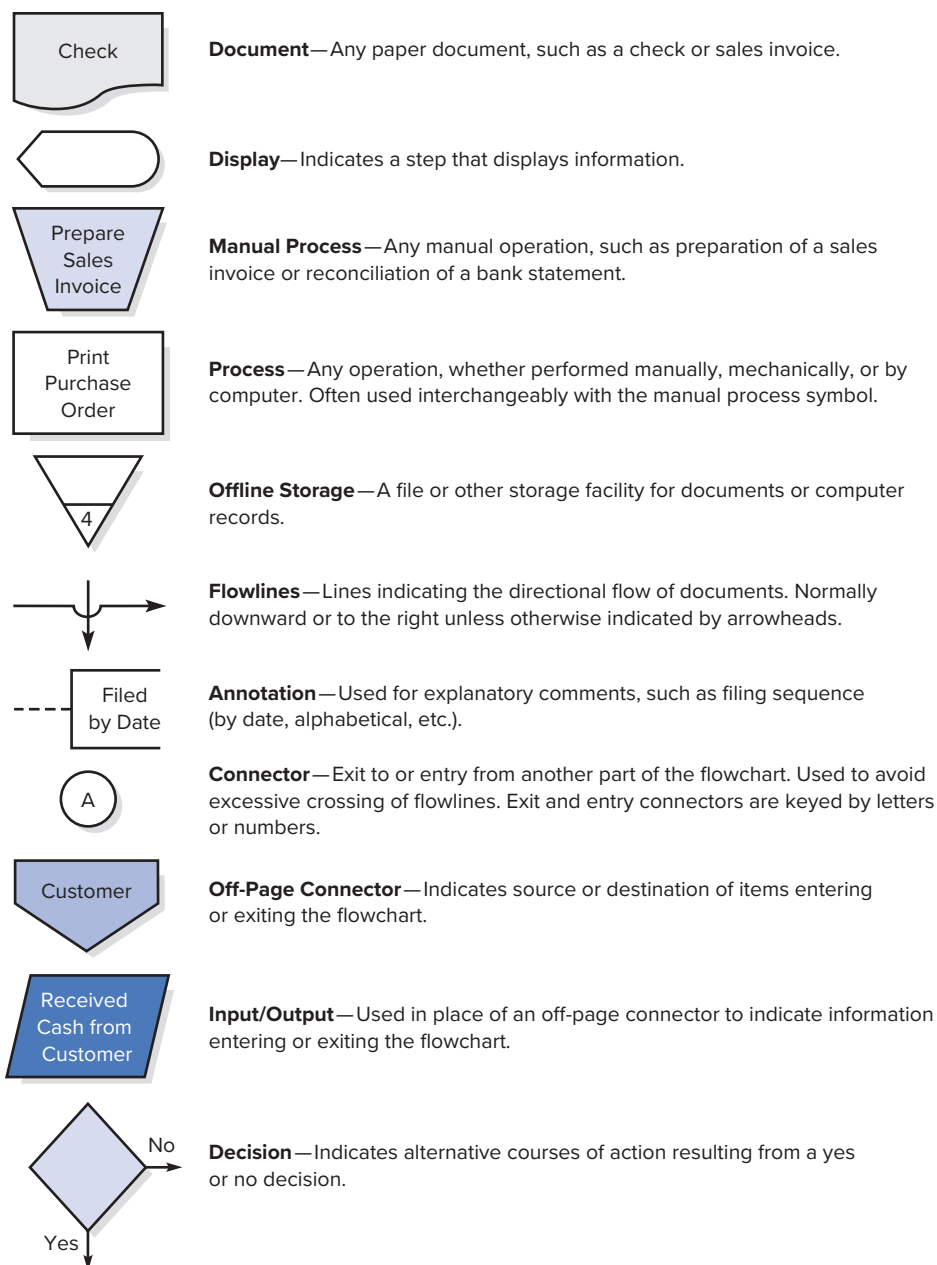
FIGURE 7.3
Internal Control
Questionnaire

Internal Control Questionnaire Cash Receipts—Sales Cycle						
Client <u>Bennington Co., Inc.</u>		Audit Date <u>December 31, 20XX</u>				
Names and Positions of Client Personnel Interviewed: <u>Lorraine Martin—Cashier; Helen Ellis—Head Bookkeeper; Wm. Dale—Manager</u>						
Question	Answer					Remarks
	Not Appl.	Yes	No	Weakness		
				Major	Minor	
1. Are all persons receiving or disbursing cash bonded?		✓				
2. Is all incoming mail opened by a responsible employee who does not have access to accounting records?			✓	✓		H. Ellis is head bookkeeper
3. Does the employee assigned to the opening of incoming mail prepare a list of all checks and money received?			✓		✓	See mitigating control in #13
4. a) Is a copy of the listing of mail receipts forwarded to the accounts receivable department for comparison with the credits to customers' accounts?	✓					
b) Is a copy of this list turned over to an employee other than the cashier for comparison with the cash receipts records?	✓					
5. Are receipts from cash sales and other over-the-counter collections recorded by sales registers or point-of-sale terminals?	✓					
6. Are the daily totals of cash registers or other mechanical devices verified by an employee not having access to cash?	✓					
7. Are physical facilities and mechanical equipment for receiving and recording cash adequate and conducive to good control?		✓				
8. Is revenue from investments, rent, concessions, and similar sources scheduled in advance so that nonreceipt on due date would be promptly investigated?	✓					
9. Do procedures for sale of scrap materials provide for direct reporting to accounting department concurrently with transfer of receipts to cashier?	✓					
10. Are securities and other negotiable assets in the custody of someone other than the cashier?	✓					
11. Are collections by branch offices deposited daily in a bank account subject to withdrawal only by home office executives?	✓					
12. Are each day's receipts deposited intact and without delay by an employee other than the accounts receivable bookkeeper?		✓				
13. Are the duplicate deposit tickets returned by the bank and compared with the cash receipts record and mailroom list of receipts by an employee other than the cashier or accounts receivable bookkeeper?		✓				W. Dale Manager
14. Are the duplicate deposit tickets properly filed and available for inspection by auditors?		✓				Chronological sequence
15. Are NSF checks or other items returned by the bank delivered directly to an employee other than the cashier and promptly investigated?		✓				W. Dale Manager
16. Is the physical arrangement of offices and accounting records designed to prevent employees who handle cash from having access to accounting records?			✓		✓	Small company doesn't permit this
Prepared by <u>V.M. Harris</u> Date <u>Sept. 6, XX</u> Manager Review _____ Date _____ Senior Review _____ Date _____ Partner Review _____ Date _____						

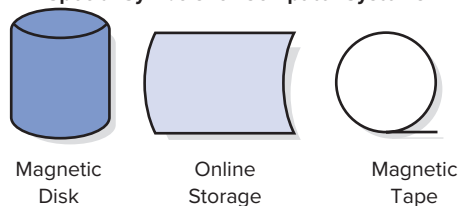
FIGURE 7.4
Written Narrative on
Internal Control

Bennington Co. Inc. Cash Receipts Procedures December 31, 20XX	
All checks are received by mail. Lorraine Martin, cashier, picks up the mail every morning at the post office and delivers it unopened to Helen Ellis, the head bookkeeper. Ellis opens and distributes the mail. Customers' checks are given to Martin, who inputs them as a batch into the cash receipts application program, which prepares duplicate deposit slips, records the cash, and posts to the accounts receivable subsidiary ledger. Martin deposits the checks intact at the First National Bank and returns with a validated duplicate deposit slip, which Ellis files chronologically. Any customers' checks charged back by the bank are given by Ellis to the manager, William Dale, who follows up and redeposits the checks. Ellis also forwards monthly bank statements unopened to Dale. Dale reconciles the monthly bank statement, compares the dates and amounts of deposits with the entries in the cash receipts journal, and reviews the propriety of sales discounts recorded in the cash receipts journal. Martin, Ellis, and Dale are all bonded.	
Val Martin Harris September 6, 20XX	

FIGURE 7.5
Widely Used
Flowcharting Symbols

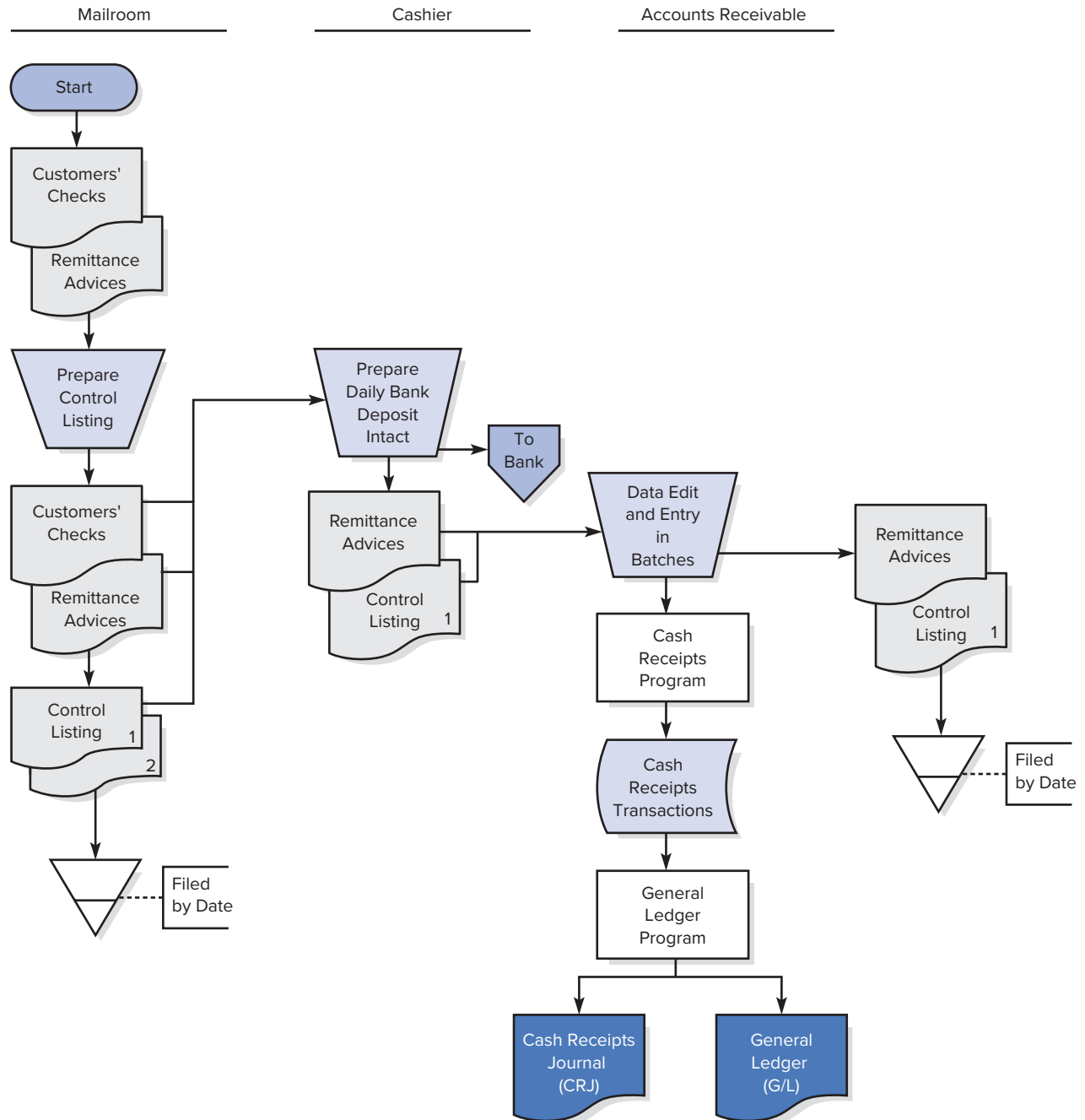


Special Symbols for Computer Systems



distribution of documents, and types and location of accounting records and files. The standard symbols used in systems flowcharting are illustrated in Figure 7.5; however, the symbols used and the flowcharting technique vary somewhat among different public accounting firms.

Separate systems flowcharts are prepared for each major transaction cycle. Each flowchart is divided into vertical columns representing the various departments (or employees) involved in processing the transactions. Departmental responsibility for procedures,

FIGURE 7.6 Cash Receipts Flowchart

V.M.H.
September 6, 0X

documents, and records is shown by reviewing the related flowcharting symbol beneath the appropriate departmental heading. Flowcharts usually begin in the upper left-hand corner; directional flowlines then indicate the sequence of activity. The normal flow of activity is from top to bottom and from left to right. These basic concepts of systems flowcharting are illustrated in Figure 7.6.

The advantage of a flowchart over a questionnaire or a narrative is that a flowchart provides a clearer, more specific portrayal of the client's system. There is less opportunity

for misunderstanding, omitted areas, or ambiguous statements when one uses lines and symbols rather than words to describe internal control. Furthermore, in each successive annual audit, updating a flowchart is a simple process requiring only that the auditor add or change a few lines and symbols.

A possible disadvantage of flowcharts is that internal control weaknesses are not identified as prominently as in questionnaires. A “no” answer in an internal control questionnaire is a conspicuous red flag calling attention to a dangerous situation. A flowchart may not provide so clear a signal that a particular control is absent or is not being properly enforced. For that reason, some CPA firms use both flowcharts and questionnaires to describe internal control. The flowchart clearly depicts internal control, while the questionnaire serves to remind the auditors of controls that should be present.

The Walk-Through

After describing internal control in their working papers, the auditors often will verify that it has been implemented by performing a walk-through of each transaction cycle. The term **walk-through** refers to tracing one or two transactions through each step in the cycle. To perform a walk-through of the sales and collections cycle, for example, the auditors might begin by selecting several sales orders and following the related transactions through the client’s sequence of procedures. The auditors would determine whether such procedures as credit approval, shipment of merchandise, preparation of sales invoices, recording of the accounts receivable, and processing of the customers’ remittances were performed by appropriate client personnel and in the sequence indicated in the audit working papers.

While performing a walk-through, the auditors will ask questions of the company’s employees concerning the procedures they perform and their related responsibilities at important processing stages. These inquiries and the other walk-through procedures allow the auditors 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. Also, inquiries that go beyond a narrow focus on the single transaction used as the basis for the walkthrough allow the auditor to gain an understanding of the different types of significant transactions handled by the process. If the auditors find that internal control functions differently from the working paper description, they will modify the working papers to describe the actual process.

Assess the Risks of Material Misstatement

LO 7-5

Explain how internal control relates to a financial statement audit.

In Chapter 5 we introduced the concept of assessing the risks of material misstatement at the financial statement and assertion levels, while in Chapter 6 we provided further details. The overall approach (summarized) is

- Identify risks of material misstatement by performing risk assessment procedures.
- Assess identified risks of material misstatement at the financial statement level.
- Assess identified risks of material misstatement at the assertion level.
- Design further audit procedures (tests of controls and substantive procedures) in response to the identified risks of material misstatement.

The auditors’ understanding of the entity’s internal control is a key input in identifying the risks of material misstatement. For example, the auditors use their understanding of the client’s information system to identify risks of material misstatement that relate directly to the recording of transactions such as the following:

- Routine transactions (e.g., revenue, purchases, and cash receipts and disbursements).
- Nonroutine transactions (e.g., taking of inventory, calculating depreciation expense).
- Estimation transactions (e.g., determining the allowance for doubtful accounts).

Because strong controls over an area are likely to result in the proper recording of transactions, the expected effectiveness of internal control is often a key factor in assessing the risks of material misstatement. But as we discussed earlier in this chapter, nonroutine and estimation transactions are often difficult to control.

When the auditors assess the risks of material misstatement at this stage of the audit, they have little information on the actual effectiveness of controls. Ordinarily they know the system as it has been described to them, and they have determined that it has been implemented. This allows them to assess only the effectiveness of the design of the system. If they wish to rely on the controls with respect to particular assertions, they should perform tests of controls to obtain audit evidence about their actual effectiveness.⁴

Assess Risks at the Financial Statement Level

As we discussed in detail in Chapter 6, risks at the financial statement level are those that relate to the overall financial statements and potentially affect many individual assertions. The following are internal control–related examples of risks at the financial statement level:

- Controls over the preparation of the financial statements, including the development of significant accounting estimates and the preparation of the notes.
- Selection and application of significant accounting policies.
- IT general controls (these controls are discussed in further detail in Chapter 8).
- The control environment.

Risks such as these potentially affect many relevant assertions in that their effects cannot effectively be isolated. In addition to the various accounts they may affect, these risks are difficult for the auditors because assessing the associated risks often requires considerable judgment. For example, poorly controlled access to the IT system may allow unauthorized personnel to access and inappropriately change data of many types. Questions about the integrity of management also may raise a variety of questions relating to the financial statements. Because of these characteristics of financial statement level risks, an overall response by the auditor is often required. As presented in Chapter 6, responses might include

- Assigning more experienced staff or those with specialized skills.
- Providing more supervision and emphasizing the need to maintain professional skepticism.
- Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed.
- Increasing the overall scope of audit procedures, including their nature, timing, or extent.

Assess Risks at the Relevant Assertion Level

Some risks of misstatement relate to one or a few **relevant assertions**. For example, risks associated with the failure to recognize an impairment loss on a long-lived asset might affect only the valuation assertion and related impairment loss associated with that asset. Risks related to inaccurate counting of inventory at year-end affect the valuation of inventory and the accuracy of cost of goods sold.

Recall that relevant assertions are identified without consideration of any related controls. Yet, while obtaining an understanding of the client, auditors will have obtained information on both the design and implementation of controls. When the design itself is deficient, the issue of whether the control has been implemented loses importance because it is unlikely that the control will be effective.

⁴ As we have indicated in Chapter 5, the process is not as sequential as implied. Auditors sometimes perform a number of tests of controls while obtaining an understanding of internal control. Also, the very implementation of certain automated controls may imply operating effectiveness. Our point is that simply obtaining an understanding of the system and its implementation is not ordinarily sufficient to evaluate its operating effectiveness.

When the design is effective, auditors should determine that the control has been implemented and that it exists more than simply “on paper.” Determining whether it has been implemented ordinarily involves observing the procedure. The auditors may also decide to perform further audit procedures to determine whether the controls operate effectively—these procedures are tests of controls. Also, recall from Chapter 6 that the professional standards require the auditors to design and perform substantive procedures for all relevant assertions.

A decision to perform tests of controls is based on both the auditors’ consideration of whether controls are likely to be operating effectively and whether testing those controls is likely to be cost-effective. In other words, the auditors should ask themselves, “Is the time required to perform tests of controls to justify a lower assessment of control risk justified in terms of its resulting decrease in the scope of substantive procedures?” The lower **assessed level of control risk** (and risk of material misstatement) is appropriate only when the auditors have evidence on the operating effectiveness obtained by performing tests of controls.

The auditors’ approach also may be dictated by other audit evidence that is available and by the nature of the client’s information system. For example, when the client uses a sophisticated information technology system, the auditors may conclude that substantive procedures cannot, in and of themselves, provide sufficient audit evidence. When this is the case, there may be no other option than relying upon a combination of tests of controls and substantive procedures.

Design and Perform Further Audit Procedures

After assessing the risks of material misstatement, the auditors consider what can go wrong and design further audit procedures. Further audit procedures ordinarily consist of substantive procedures and, when the assessed level of risk presumes that controls operate effectively, tests of controls. At this point, the risk assessments are preliminary because the auditors may be assuming that controls that have not been tested are operating effectively. The preliminary assessments of control risk are often referred to as the auditors’ *planned assessed levels of control risk*. They will be modified when tests of controls indicate that controls are not operating at the planned assessed level.

Tests of controls can focus on either financial statement or assertion level controls. Ordinarily, controls that operate at the financial statement level, such as the control environment or **IT general controls**, are only indirectly related to particular assertions. The emphasis for tests of controls should ordinarily be upon the operating effectiveness of controls that are directly related to relevant assertions. In addition, the auditors will consider the need to obtain audit evidence on the effective operation of financial statement level controls on which the effectiveness of direct controls depends.

Tests of Controls

LO 7-6

Describe the major types of tests of controls.

The auditors perform tests of controls to obtain evidence about the operating effectiveness of controls. The approach is to (1) identify the controls likely to prevent or detect material misstatements and (2) perform tests of controls to determine whether they are operating effectively. Tests of controls address the following:

- How controls were applied.
- The consistency with which controls were applied.
- By whom or by what means (e.g., electronically) the controls were applied.

As indicated previously, the auditors may have gathered some evidence about the effectiveness of certain controls while they performed procedures to obtain an understanding of internal control and determined that the controls were implemented. For example, in evaluating the design of the control environment, the auditors may have made inquiries

about management's use of budgets, observed management's comparison of monthly budgeted and actual expenses, and inspected reports pertaining to the investigation of variances. For efficiency purposes, the auditors may have decided to perform virtually all of the tests of controls during the process of obtaining an understanding of internal control. However, for many audits, the auditors will design additional tests of controls at this point to support their planned assessed level of control risk. The auditors will use their understanding of the client's internal control to design these additional tests of controls.

Nature of Tests of Controls

The audit procedures used to test the effectiveness of internal control include

- *Inquiries* of appropriate client personnel.
- *Inspection* of documents and reports.
- *Observation* of the application of controls.
- *Reperformance* of the controls.

Tests of controls focus on the operation of controls rather than on the accuracy of financial statement amounts. To illustrate this distinction, assume that the client has implemented the control of requiring a second person to review the quantities, prices, extensions, and footing of each sales invoice. The purpose of this control is to prevent material errors in the billing of customers and the recording of sales transactions.

To test the operating effectiveness of this control of requiring a second-person review, the auditors may make inquiries of client personnel and observe application of the procedure. They also might select a sample of, say, 30 sales invoices prepared throughout the year. They would inspect the invoice copy for the initials of the reviewer and reperform the procedure by comparing the quantities to those listed on the related shipping documents, comparing unit prices to the client's price lists, and verifying the extensions and footings. The results of this test provide the auditors with evidence as to the existence and valuation of the recorded sales and accounts receivable. If numerous deviations from the control are found, the auditors will expand their substantive procedures with respect to existence and valuation of accounts receivable and sales transactions. For example, a substantive test of financial statement amounts might involve selecting a sample of recorded sales transactions to determine that they have been properly recorded and included in the year's total sales.

In testing **management review controls**, the auditors generally examine a sample of review or exception reports, reperform selected reviews, and determine that the exceptions or unusual items were appropriately investigated and resolved. The testing of management review controls can also provide insight into the operating effectiveness of other controls.

The controls described above leave documentary evidence of performance that allows them to be tested by sampling. Controls that do not leave documentary evidence of performance may be tested entirely through observation by the auditors and inquiry of client personnel. Segregation of duties, for example, is tested by observing the client's employees as they perform their duties and inquiring as to who performed those duties throughout the period under audit. The auditors also should determine whether employees performed *incompatible duties* when other employees were absent from work on sick leave or vacation.

Timing of Tests of Controls

Timing of the performance of tests of controls depends upon the auditors' objectives. If the auditors test the operation of controls at a particular time, their audit evidence generally relates only to that time (e.g., tests of counting procedures performed during the annual physical inventory counting at period end). However, tests of certain controls provide evidence about operating effectiveness throughout the period (e.g., tests of general controls pertaining to modifying and using a computer program). For many controls,



Illustrative Case

Testing Management Review Controls

In the audit of a commercial enterprise with four similar branch locations, the auditors

select for testing a monthly management review control over the existence, completeness, and allocation assertions for certain selling, general, and administrative expenses. In performing the control, each branch controller performs an analysis comparing the expense accounts in the branch's financial statements to the prior year and forecasted financial statements for the branch and investigates differences over a set amount. The branch controllers discuss the results of the analysis with the company CFO to enable the CFO to understand the basis for significant differences and determine whether any financial statement adjustments or other corrective actions are needed.

To evaluate the effectiveness of the control, the auditors perform the following procedures:

- a. Evaluate whether the control addresses the risks of material misstatement to the relevant assertions of the selling, general, and administrative expense accounts, as intended;
- b. Evaluate whether the use of prior year and forecast information at the branch level is an appropriate basis for establishing expectations to identify potential misstatements;
- c. Evaluate whether the criteria used for identifying differences for investigation are set at an appropriate level to enable the branch controller to identify material misstatements;
- d. Evaluate the competencies of the CFO and branch controllers;
- e. Evaluate whether the control operates often enough to prevent or detect misstatements before they have a material effect on the financial statements;
- f. On a test basis, obtain the information used by the branch controller in the review, understand the steps performed by the branch controller to investigate significant differences, reperform the analysis and compare it to the auditor's identification of significant differences and evaluation of results; and
- g. Read summaries of selected meetings in which the results of the analyses by the branch controllers were discussed with the CFO; and evaluate the matters discussed, conclusions reached, and corrective actions taken.

Adapted from PCAOB Staff Audit Practice Alert No. 11, "Considerations for Audits of Internal Control over Financial Reporting."

the auditors will want evidence on operating effectiveness by sampling the application of controls from throughout the period.

Extent of Tests of Controls

The general approach to increasing the evidence from a test of control is to increase the extent of the test (e.g., increase the number of items tested). However, automated controls provide an exception to this approach. Because of the inherent consistency of operation of automated controls, the auditors often use an audit approach of determining that the control is working at a point in time and that no inappropriate changes were made to the program during the period. In such cases, determining that a control has been implemented may be sufficient to serve as audit evidence on operating effectiveness. Chapter 9 discusses determining sample sizes for tests of controls.

Evidence from Tests of Controls Performed in Prior Audits

When the client has been audited in prior years, the auditors may have obtained evidence about the operating effectiveness of controls from tests performed in those audits. If the auditors plan to use this evidence, they should obtain evidence about whether changes in specific controls have occurred subsequent to the prior year's audit. If there have been changes, the new controls should be tested in the current audit to provide a basis for reducing control risk. However, if the auditors determine that the controls have not changed, they may rely on evidence of operating effectiveness obtained from prior years' audits. But to what extent may they rely upon them? Both AICPA and *International Auditing Standards* require that tests of control be performed at least every third audit. PCAOB standards do not allow limiting the testing of controls to every third audit—PCAOB standards provide that annually some evidence regarding operating effectiveness should be obtained when controls are relied upon. Also, the three sets of standards all require that when auditors intend to rely on controls relating to a significant risk, they should test the operating effectiveness of those controls in the current period.

Revise the Risk of Material Misstatement Based on the Results of Tests of Controls

After the auditors have completed the tests of controls, they should determine if it is necessary to revise their assessed levels of control risk (or risks of material misstatement) based on the results of those tests. If the results indicate that controls operated as effectively as had been assumed, no revision is necessary. The original audit plan is still appropriate. However, if the results reveal that controls are less effective than had been originally thought (i.e., control risk is higher than originally assessed), the auditors will revise their planned assessments and carefully consider the possible misstatements that may exist in the financial statements. Then, they will design additional substantive audit procedures to address the additional risk of misstatement.

Although unlikely, a final possibility is that controls are found to operate more effectively than expected. In this case, modifications may include a decrease in the extent of substantive audit procedures.

Design and Perform Substantive Procedures

The auditors' assessment of the risk of material misstatement (or separate assessments of inherent and control risks) determines the nature, timing, and extent of substantive audit procedures for the various assertions in the financial statements. For assertions with a high risk of material misstatement, the auditors will plan substantial substantive procedures. On the other hand, when the assessments of the risk of material misstatement of an assertion are low, the substantive procedures will be restricted or in some circumstances eliminated for that assertion. Chapters 10 through 16 provide details of the way in which auditors design substantive procedures for various accounts and assertions.

The auditors' consideration of internal control is complex. Figure 7.7 is a flowchart that highlights the major steps in the auditors' consideration of internal control.

Effects of Data Analytics

In Chapter 5 we discussed the increasing role of **data analytics** in audits. This role may have a very major effect upon the nature, timing, and extent of tests of controls. While we provide detailed illustrations in Chapters 10 through 16, following is a general overview.

As discussed previously, auditors may select samples of transactions to test the operating effectiveness of certain controls. Such samples provide evidence about the operating effectiveness of the controls, and auditors use professional judgment to combine the results of these tests and other types of tests to assess control risk for the various assertions. This assessment is then used to determine the scope of substantive procedures aimed at restricting detection risk. Indeed, this is still an approach used in many audits.

Data analytics are increasingly being used as a supplement or alternative to certain sampling tests. While a number of approaches are possible, consider the following two: (1) test a number of controls simultaneously electronically through a sample of transactions and follow up by using additional data analytics to audit the entire population of transactions for any controls whose operating effectiveness is in question or (2) use data analytics to test a control for 100 percent of the transactions in a particular population. Either approach may provide evidence about the operating effectiveness of controls, as well as identification of possible needed adjustment to the financial statements.

Documentation

The auditors' consideration of internal control is documented as a part of the overall risk assessment and evidence accumulation process. In addition to documenting their overall understanding of internal control, the auditors should document

- The overall responses to address the assessed risks of material misstatement at the financial statement level.
- The nature, timing, and extent of the further audit procedures.
- The linkage of those procedures with the assessed risks at the relevant assertion level.
- The results of the audit procedures.
- The conclusions reached with regard to the use of the current audit evidence about the operating effectiveness of controls that was obtained in a prior audit.

FIGURE 7.7
The Auditors’
Consideration of
Internal Control

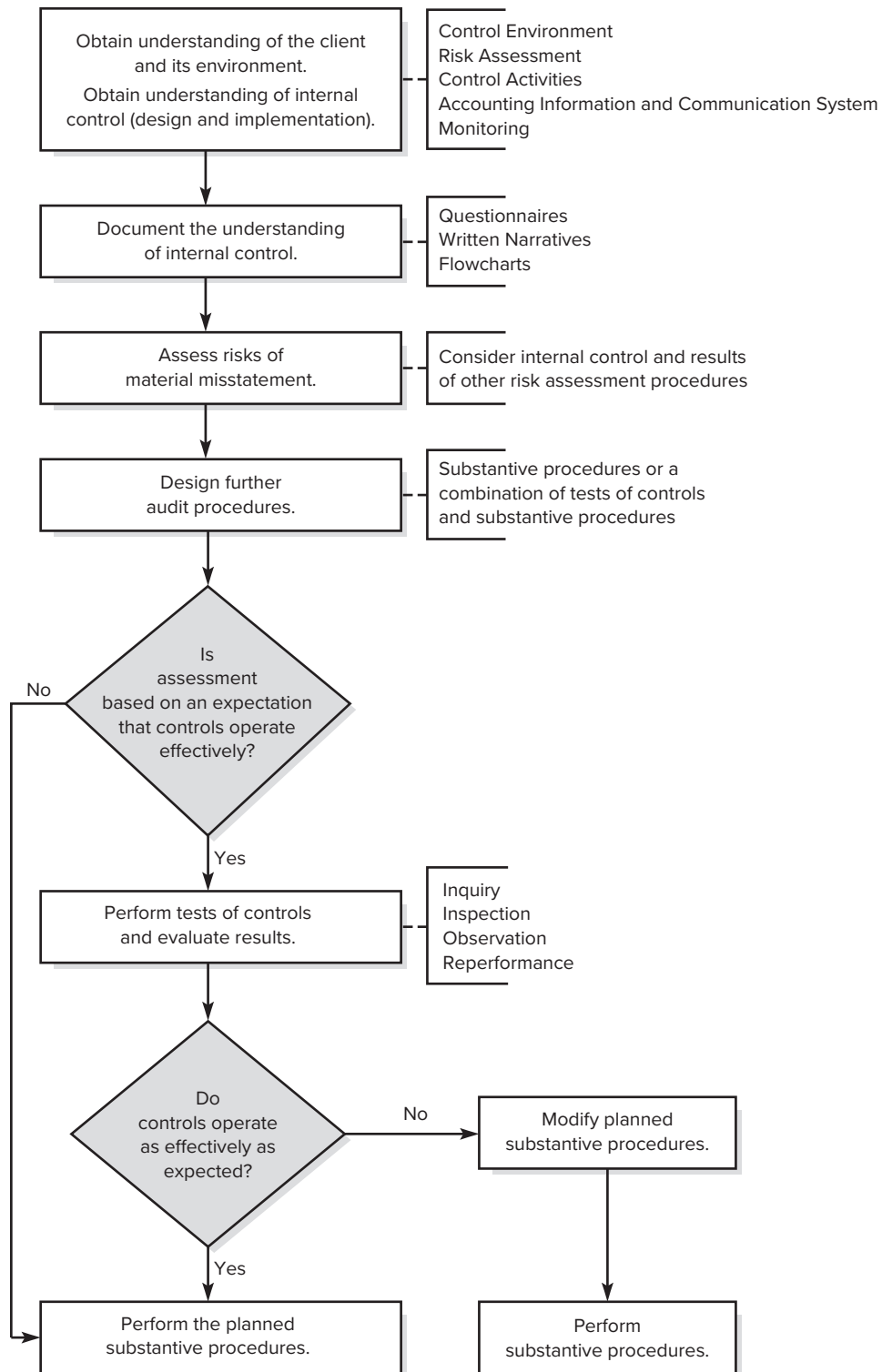


Figure 7.8 provides an illustration of a working paper summarizing the auditors' assessment of inherent risk, control risk, and the combined risk of material misstatement.

Decision Aids for Audit Plan Modification

Modifying audit plans (programs) for various levels of control risk while considering other factors such as levels of materiality and inherent risk involves complex judgments. How many additional items should the auditors test to compensate for high control risk? Is the risk of material misstatement for a particular assertion low enough to make it

FIGURE 7.8 Working Paper for Summarizing Assessment of Risk

Client: <u>Arntco Inc.</u>		Date: <u>9/16/X3</u>			Reviewed by: <u>K.J.</u>			Balance Sheet Date: <u>12/31/X3</u> Date: <u>10/28/X3</u>	
Completed by: <u>R.W.</u>		Description of Risk		Significant Risk?	Relevant Assertion(s)	Assessed Risk of Material Misstatement (see A-6 explaining the basis for these determinations)			Summary of Audit Approach
W/P	Ref					Inherent Risk	Control Risk	Combined Risk of Material Misstatement	
B-6				Yes	Existence/ Occurrence	Moderate	High	Moderate	- Confirm a sample at 12/3. Ask about any disputes over invoices and compare to internal files to confirm accuracy of company records provided. - Perform limited sales cutoff tests. - Be alert to sales occurrence issues related to sales from 1st 9 months. - Use computer data extraction to perform detailed substantive analytical procedures.
B-9			Gross Receivables and Gross Sales	No	Completeness	Moderate	High	Moderate	
B-6		No		Accuracy	Moderate	High	Moderate		
B-11		No		Cutoff	Low	High	Low*		
B-11		No		Completeness	Low	High	Low		

*The low exposure at year-end due to closing the business for an extended holiday was considered in reaching this conclusion and was documented. See Brainstorming Session documentation at A-23.
Source: Adapted from AICPA, *Audit Guide: Assessing and Responding to Risk in a Financial Statement Audit*, 2016.

feasible to test the assertion at an interim date rather than at year-end? Without guidance from the CPA firm, different auditors within that firm might arrive at different answers to these questions. In fact, research on these types of audit judgments has revealed just that; there is a good deal of variance in auditors' decisions.

CPA firms initially reacted to this problem by developing policies that place limits on individual auditors' decisions. The establishment of minimum audit sample sizes for particular types of tests is an example of such a policy. More recently, CPA firms have attempted to add even more structure to auditors' decisions through the use of decision aids or guides. An **audit decision aid** is a checklist, standard form, or computer program that helps the auditors make a particular decision by ensuring that they consider all relevant information or by assisting them in combining the information to make the decision. By reducing the variance in auditors' judgments, an aim in using decision aids is to promote the performance of audits that meet firm and professional requirements.

Using the Work of Internal Auditors

Much of the work performed by **internal auditors** is similar in nature to that performed by external auditors. This raises the question of how the work of internal auditors may be used by the external auditors. AICPA AU-C 610 and PCAOB AS 2605 indicate that the external (independent) auditors may use the work of internal auditors in the following two ways:

1. Obtaining audit evidence by using the internal auditors' work performed as a part of their normal responsibilities and
2. Using internal auditors to provide direct assistance on the external audit.

As indicated in the discussion of the components of internal control, the internal audit function is an important part of the client's internal control, risk management, and governance system. In performing their monitoring and control function, internal auditors perform procedures that are similar to those performed by the external auditors. For example, internal auditors usually perform tests of controls, tests of compliance with laws and regulations, and substantive tests that are relevant to the audit of the client's financial statements.

In determining whether the internal auditors' work will be used, the external auditors begin by obtaining an understanding of the work to determine if it is relevant to their audit. They make inquiries about such matters as the internal auditors' activities and plans. If the external auditors decide the work is relevant and it would be efficient to use it, they should assess the *competence* and *objectivity* of the internal audit function and determine whether the internal auditors apply a *systematic and disciplined approach* to performing the work, including the application of appropriate quality control.

In evaluating the competence of the internal audit function, the external auditors evaluate the internal auditors' policies for hiring, training, and assigning personnel to engagements. They evaluate whether the internal audit function is adequately and appropriately staffed. They also consider whether individual auditors are adequately trained and proficient by evaluating their education level, professional experience, and professional certifications. Finally, the external auditors investigate the internal auditors' policies, programs, procedures, working papers, and reports and the extent to which internal auditors' activities are supervised and reviewed.

Objectivity is evaluated by considering the organizational status of the director of internal audit, including whether the director reports to those charged with governance of the entity, such as the audit committee of the board of directors. The internal audit function should be free from conflicting responsibilities and have no constraints on its audit activities. Decisions regarding employment of the director of internal audit should rest with those charged with governance. In addition, the internal audit function should have policies that prevent individual auditors from being assigned to an engagement where they have a conflict of interest.

If, after assessing internal audit competence, objectivity, and approach, the external auditors decide to use some of the internal auditors' work, they should review that work and reperform some of the audit procedures. In deciding the nature and extent of the work to be used in a particular audit area, the external auditors should consider the judgment involved in planning and performing the procedures and evaluating the evidence, and the risk of material misstatement of the related account. In addition, judgments about assessments of risk, the materiality of misstatements, the sufficiency of tests performed, and other matters affecting the opinion must be those of the external auditors.

The internal auditors also may provide direct assistance to the external auditors in preparing working papers and performing certain audit procedures. In such cases, the external auditors should direct, supervise, review, and test the work. In determining the nature and extent of the work that can be assigned to the internal auditors, the external auditors should consider whether there are any significant threats to objectivity or competence in performing the work. They also should consider the assessed risk of material misstatement of the area being audited and the amount of judgment involved in planning and performing the procedures and evaluating the audit evidence. Examples of work that should not be assigned to internal auditors include making required inquiries of management related to the identification of fraud risks and determining the procedures to respond to such risks.⁵

When the external auditors decide to use the work of the internal auditors, they should communicate how the work will be used to those charged with governance. In addition, if they plan to use the internal auditors for direct assistance, they should obtain written acknowledgment from management and those charged with governance that the internal auditors will be allowed to perform the work free from any interference.

Consideration of Outsourced Computer Processing to Service Organizations

Service organizations provide processing services to companies that decide to outsource a portion of their processing—these latter companies are referred to as **user entities**. For example, a CPA's financial statement audit client (the user entity) may outsource its payroll function to a service organization. Indeed, as is discussed further in Chapter 8, **cloud**-based accounting systems result in major portions or even virtually entire accounting systems being hosted on remote servers by service providers.

AICPA AU-C 402 and PCAOB AS 2601 require the auditors of the financial statements of a user entity to obtain an understanding of how the entity uses the services of the service organization, including the nature and significance of the services and the effect on its internal control. If the auditors are unable to obtain a sufficient understanding from the user entity, they should obtain that understanding through performing one or more of the following procedures:

- Contact the service organization, through the user entity, to obtain specific information.
- Visit (or engage another auditor to visit) the service organization and perform necessary procedures about the relevant controls at the service organization.
- Obtain and consider a **System and Organization Controls (SOC)** audit report of the **service auditor** on the service organization's controls (a **SOC 1 report**), as described below.⁶

⁵ International auditing standards indicate that internal auditors may not provide direct assistance to perform procedures that involve (1) making significant judgments, (2) areas of higher assessed risk of misstatement where judgment is involved in performing the audit procedure or evaluating the audit evidence, (3) areas with which the internal auditors have been involved, and (4) certain other procedures, such as maintaining control over external confirmation requests.

⁶ The public accounting profession has developed a number of attestation services relating to system and organization controls (SOC). In this section we emphasize SOC 1 engagements, those in which service auditors report on the internal control over financial reporting of a service organization's system relating to the services it provides (e.g., its controls over payroll processing). We also briefly address SOC 2 and SOC 3 engagements, engagements that address one or more of the following: data security, availability, processing integrity, confidentiality, and privacy under the profession's Trust Services Criteria. Chapter 20 presents these engagements in greater detail.

When there is a low degree of interaction between the user entity's controls and those at the service organization, the auditors may find that controls applied by the user entity are adequate to obtain reasonable assurance that material misstatements (errors or fraud) are prevented or detected. For example, the user entity's personnel may develop input control totals and compare them to the service organization's output. They also may reperform computer calculations on a test basis. When such controls are adequate, the auditors need test only client controls to obtain appropriate evidence; there is no need to perform audit procedures (e.g., tests of controls) at the service organization.

As interaction between the service organization and user entity increases, the auditors may need to contact the service organization and, if necessary, perform procedures to obtain the required understanding of controls. In addition, if the audit plan includes a presumption that certain controls operate effectively, the auditors should obtain evidence of their operating effectiveness regardless of whether those controls are client controls or those of the service organization.

Most service organizations perform similar processing services for numerous clients. For example, assume that Payroll Services Inc. (a hypothetical company) performs the payroll function for 250 of its clients. If the auditors of many of those clients (the "**user auditors**") were to visit the service organization for the purpose of assessing controls, they would ask similar questions and perform similar tests. It is often more advantageous for the service organization to engage its own audit firm (a "**service auditor**") to perform an examination of its **system** relevant to user entities' internal control over financial reporting and to report on that system. After considering factors discussed below, the user auditors may then be able to rely on the report as an alternative to or in addition to performing their own procedures at the service organization.

SOC 1 for Service Organizations—the Service Auditor

AICPA AT-C 320 and PCAOB AS 2601 present guidance for performing SOC 1 examination engagements. These engagements are particularly relevant to financial statement audits in that they address a service organization's internal control over financial reporting. The approach followed on such engagements involves management of the service organization providing a description of the service organization's system and a written assertion on the suitability of the design of its controls. Then, the service auditor assesses the accuracy of the description and the assertion. In addition, management may choose to perform an assessment of the operating effectiveness of the controls within the system.

To respond to both of these options, the public accounting profession has developed engagements resulting in two different SOC 1 service auditors' reports:

- **Report on controls placed in operation (Type 1 report)**—A report on management's description of the service organization's system and the suitability of the design of controls as of a particular date.
- **Report on controls placed in operation and tests of controls (Type 2 report)**—A report on management's description of the service organization's system and the suitability of the design *and operating effectiveness of controls throughout the period covered* by the service auditor's report.⁷

Both types of SOC 1 reports include a number of matters, including (1) an indication that the engagement was performed in accordance with the attestation standards and a description of the nature of the engagement, (2) a reference to management's description of the system and the criteria used to evaluate the system, (3) an indication that management is responsible for the system, (4) an indication of the limitations of the internal controls, and (5) an opinion on the system. The following is a sample opinion section from a SOC 1, Type 2 report.

⁷ The PCOAB uses the terms "report on controls placed in operation" and "report on controls placed in operation and tests of operating effectiveness," while the AICPA uses "Type 1" and "Type 2." We will use the AICPA terms.

In our opinion, in all material respects, based on the criteria described in XYZ Service Organization's assertion:

- the description fairly presents the XYZ disbursement processing system that was designed and implemented throughout the period January 1, 20X1 to December 31, 20X1.
- the controls related to the control objectives stated in the description were suitably designed to provide reasonable assurance that the control objectives would be achieved if the controls operated effectively throughout the period January 1, 20X1 to December 31, 20X1.
- the controls operated effectively to provide reasonable assurance that the control objectives stated in the description were achieved throughout the period January 1, 20X1 to December 31, 20X1.

A Type 1 service auditor's opinion would be as of a particular date (rather than "January 1, 20X1 to December 31, 20X1" or a shorter period within 20X1) and would not include the final bullet.

A Type 2 report would also include a description of the tests of controls performed, including

- an identification of the controls that were tested;
- whether the items tested represent all or a selection of the items in the population;
- the nature of the tests in sufficient detail to enable user auditors to determine the effect of such tests on their risk assessments;
- any identified deviations in the operation of controls included in the description, the extent of testing performed by the service auditors that led to the identification of the deviations, and the number and nature of the deviations noted.

In some cases, the service organization may outsource to another service organization certain functions. For example, a service organization may use a data center to host the service organization's software or employ an organization (a subservice organization) to manage its backup and recovery system. When controls applied by the subservice organization are necessary to achieve the service organization's control objectives, the controls are referred to as **complementary subservice organization controls**. In such situations, management of the service chooses one of two service auditor reporting options: (1) the *inclusive method*, which involves including the subservice controls in the scope of the examination, or (2) the *carve-out method*, which involves excluding the subservice controls from the scope of the examination. If management elects the carve-out method, the service auditors report should state that

- management's description of the service organization's system excludes the control objectives and related controls of the relevant subservice organization,
- certain control objectives specified by the service organization can be achieved only if complementary subservice organization controls assumed in the design of the service organization's controls are suitably designed and operating effectively, and
- the service auditors' procedures do not extend to such complementary subservice organization controls.

Occasionally, the effectiveness of the service organization's controls depends on control procedures performed by the user entities. In these cases, management's description of the service organization's system should refer to the need for **complementary user entity controls**, and the service auditors' reports should state that (1) the service auditors have not evaluated the suitability of the design or operating effectiveness of complementary user entity controls and (2) the control objectives stated in the description can be achieved only if complementary user entity controls are suitably designed and operating effectively, along with the controls at the service organization.



Illustrative Case

Auditor Use of a Service Organization Report

Payroll Services Inc. is a service organization that specializes in providing payroll processing services to its clients. When the financial statements of its clients are audited, the auditors of a number of these organizations need information about Payroll Services' internal control over financial reporting relating to its processing of payroll. To provide this information to auditors of the user entities (its clients), a CPA firm (service auditor) is engaged by Payroll Services to (1) perform an examination of its system and controls for payroll services and (2) issue a report relating to that system.

Assume that Payroll Services engaged the service auditor to perform what is referred to as a SOC 1, Type 2 engagement. Such an engagement results in a service auditors' report on

1. The fairness of the presentation of management's description of the service organization's system,

2. The suitability of the design of the system, and
3. The operating effectiveness of the controls to achieve the related control objectives included in the description throughout a specified period.

CPA firms involved with financial statement audits of Payroll Service's clients may use the service auditor's report to obtain information needed to audit payroll transactions relating to the financial statements. If the service auditor was not engaged to perform tests of controls, no assurance would have been provided on operating effectiveness in the service auditor examination report (a SOC 1, Type 1 report) and auditors of Payroll Service's clients would need to consider this when designing their other audit procedures.

If during the performance of subsequent procedures the service auditors become aware of an event that is of such a nature and significance that its disclosure is necessary to prevent users of a Type 1 or Type 2 report from being misled, and information about that event is not disclosed by management in its description, the service auditors should disclose the information in the service auditors' report.

SOC 1 for Service Organizations—User Auditors

If the service auditors' report provides an adequate basis for the user auditors' assessment, there usually is no need for the user auditors to perform their own tests at the service organization. When the user auditors' risk assessment includes an expectation that controls at the service organization operate effectively, the user auditors should obtain a Type 2 report (if available) or perform appropriate additional procedures.

A service auditors' report should not be referred to in a user auditors' report that contains an unmodified opinion. However, the service auditors' report may be referred to in a user auditors' report that includes a modified opinion (including a disclaimer of opinion) when the user auditors consider it relevant to understanding the modification of the opinion.

To this point we have spoken entirely of SOC 1 examination engagements. For comparison purposes, we now briefly present SOC 2 and SOC 3 examinations.

SOC 2 and SOC 3 for Service Organizations

As discussed in detail in Chapter 20, CPA firms may also issue reports on controls at a service organization that relate to one or more of the **trust services** criteria developed by the public accounting profession: security, availability, processing integrity, confidentiality, and privacy. **SOC 2 reports**, which may be of either Type 1 or Type 2, have broader applicability as they are appropriate for use by the service organization itself and user stakeholders such as customers, regulators, business partners, suppliers, and directors. However, Type 2 reports are still restricted to specific parties. **SOC 3 reports** must be of Type 2—that is, they must include an opinion on the fairness of management's assertion that controls were effectively designed and operating effectively during the period. SOC 3 reports are general purpose reports that are not restricted as to their use.

We've now introduced SOC 1, SOC 2, and SOC 3 examination engagements. While a service organization may have specific needs and select one of the three, many organizations engage their CPAs to perform all three services to meet its various needs.

Communication of Control-Related Matters

LO 7-7

Describe the auditors' responsibility for communicating control-related matters.

While establishing and maintaining effective internal control is an important responsibility of management, providing independent oversight over internal control and the company's financial reporting process is the responsibility of the audit committee or a similar body charged with governance. The auditors may provide assistance to management and the audit committee by communicating internal control deficiencies and material weaknesses (and an explanation of their potential effects) that they have identified during the audit process, often along with recommendations for corrective action. This is a service in addition to issuance of the audit report. In fulfilling this responsibility, the auditors should understand the concepts of a deficiency in internal control, a significant deficiency, and a material weakness. Auditing standards require communication of the latter two.

A **deficiency in internal control** over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect material misstatements on a timely basis. A **significant deficiency** is a deficiency in internal control over financial reporting (or combination of deficiencies) that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.⁸

A **material weakness** is a deficiency in internal control over financial reporting (or a combination of deficiencies) such that there is a reasonable possibility that a material misstatement of the company's financial statements will not be prevented or detected on a timely basis.

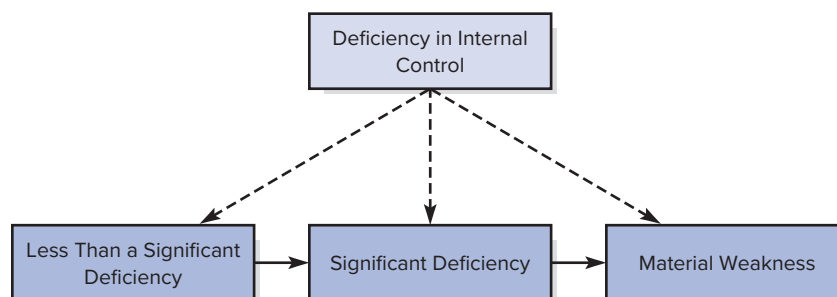
The magnitude of a misstatement that might result from a deficiency, or deficiencies, in internal control is determined by factors such as the amounts or total of transactions

FIGURE 7.9
Comparison of Control Deficiencies in Internal Control

Deficiency	Severity	Required Communication to Management and Those Charged with Governance?
Less Than a Significant Deficiency	Not directly considered	To management if deficiency merits management's attention*
Significant Deficiency	Less severe than a material weakness	Yes
Material Weakness	Reasonable possibility of a material misstatement	Yes

*As discussed in Chapter 18, PCAOB AS 2201 requires written communication of all such deficiencies to management when an audit of internal control is performed.

FIGURE 7.10
Relationships among Control Deficiencies



⁸ The COSO internal control framework uses the term *major deficiency* to refer to a deficiency that management concludes does not reduce to an acceptable level the risk of achieving the organization's objectives.

exposed to the deficiency, and the volume of activity in the class of transactions or account balance exposed to the deficiency. Figures 7.9 and 7.10 illustrate the relationships among control deficiencies, significant deficiencies, and material weaknesses.

As indicated previously, the auditors are required to communicate both significant deficiencies and material weaknesses to management and those charged with governance. This communication must be in writing. Figure 7.11 presents an example of a letter to an audit committee. Notice that the last paragraph of the letter limits its use to the audit committee, management, and others in the organization.

FIGURE 7.11
Report to Audit
Committee

Wilson & Quinn

Certified Public Accountants

1134 California Street

San Diego, California 92110

March 12, 20X2

Audit Committee of the Board of Directors
Fleet Feet Shoe Stores Inc.
2567 University Blvd.
San Diego, California 92105

Committee members:

In planning and performing our audit of the financial statements of Fleet Feet Shoe Stores, Inc., for the year ended December 31, 20X1, we considered its internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on internal control. Our consideration of internal control would not necessarily disclose all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed below, we noted certain deficiencies involving internal control that we consider to be significant deficiencies and material weaknesses under auditing standards established by the American Institute of Certified Public Accountants. A *significant deficiency* is a deficiency in internal control over financial reporting (or combination of deficiencies) that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

A *material weakness* is a deficiency in internal control over financial reporting (or a combination of deficiencies) such that there is a reasonable possibility that a material misstatement of the company's financial statements will not be prevented or detected on a timely basis. We believe that the following deficiency constitutes a material weakness:

Capitalization of certain repairs and maintenance expense items. A material amount of certain of these expense items was improperly recorded into the property and plant asset accounts. The company's controls related both to the original recording and to the review of that recording were ineffective in preventing or detecting the misstatements. We recommend that a competent accounting clerk be given the responsibility for reviewing items capitalized in property and plant asset accounts.

We consider the following deficiency to be a significant deficiency in internal control:

Failure to prepare certain receiving reports. Personnel at individual stores failed to prepare receiving reports for shipments of goods directly from wholesalers. This significant deficiency increases the chance that the company will pay for merchandise that has not been received. We recommend that a policy be established requiring the preparation of receiving reports for all shipments received from suppliers.

This report is intended solely for the information and use of the audit committee (board of directors, board of trustees, or owners in owner-managed enterprises), management, and others within the organization (and specified regulatory agency) and is not intended to be and should not be used by anyone other than these specified parties.

Sincerely,

James Wilson

Wilson & Quinn, CPAs

Because timely communication is particularly important to management, the auditors ordinarily report significant deficiencies and material weaknesses as they are discovered during the course of the audit. The exact timing is influenced by the urgency of needed corrective follow-up action, but such communication should be no later than 60 days following the report release date.

Auditors communicate deficiencies that are less than significant to management (either orally or in writing) when they believe that they deserve management's attention. These matters are typically communicated to management in a **management letter**. This letter serves as a valuable reference document for management and also may serve to minimize the auditors' legal liability in the event of a defalcation or other loss resulting from a weakness in internal control. Many auditing firms place great emphasis upon providing clients with a thorough and carefully considered management letter. These firms recognize that such a report can be a valuable and constructive contribution to the efficiency and effectiveness of the client's operations. The quality of the auditors' recommendations reflects their professional expertise and creative ability and the thoroughness of their investigation. The auditors also may communicate these less-than-significant deficiencies to those charged with governance when they are asked to provide such information.

Internal Control Reporting by Public Companies and Their Auditors

LO 7-8

Describe the nature of the audits performed under Section 404(b) of the Sarbanes-Oxley Act of 2002.

As is discussed further in Chapter 18, the Sarbanes-Oxley Act of 2002 requires certain large public (issuer) companies to provide reports on internal control by both management and the auditors. The requirements for the report by the auditors go well beyond those of the reports to management and those charged with governance described in the preceding section; it must be based on an audit of internal control. In Chapter 18, we present detailed information on audits of internal control, but in this section, we provide a brief overview of the audit and reporting requirements of the Sarbanes-Oxley Act.

Section 404 of the Sarbanes-Oxley Act is composed of two subsections. Section 404(a) requires each annual report (e.g., Form 10-K) filed with the Securities and Exchange Commission to include a report in which management (1) acknowledges its responsibility for establishing and maintaining adequate internal control over financial reporting (hereafter, internal control) and (2) provides an assessment of internal control effectiveness *as of the end of the most recent fiscal year* (the "**as-of date**"). To have an adequate basis to issue this report, management must

- Accept responsibility for the effectiveness of internal control.
- Evaluate the effectiveness of internal control using suitable control criteria.
- Support the evaluation with sufficient evidence.

Section 404(b) of the act requires most companies' auditors to attest to, and report on, internal control over financial reporting. As is discussed in further detail in Chapter 18, as currently implemented, this Section 404(b) requirement does not in general apply to companies with less than \$250 million in market capitalization or \$100 million in revenues the preceding year.

Public Company Accounting Oversight Board (PCAOB) standards provide guidance to the auditors for meeting Section 404(b)'s requirements. PCAOB standards (1) describe an **integrated audit** that addresses both the financial statements and internal control and (2) provide specific requirements for the audit of internal control.

Recall from Chapter 1 that essential to performing an attest engagement is the existence of **suitable criteria** that serve as the standards or benchmarks to measure and present the subject matter. The Committee of Sponsoring Organizations (COSO) internal control framework provides "suitable control criteria" for management's internal control report and the auditors' audit of internal control. Therefore, for an integrated audit, there are two sets of suitable criteria involved: COSO for the internal control audit and the applicable financial reporting framework for the financial statement audit.

As you would expect, the requirements to perform an integrated audit result in an increase in audit procedures directed toward testing the effectiveness of internal control. As we have discussed throughout this chapter, evidence to support the auditors' opinion on financial statements comes from a combination of tests of controls and substantive procedures. For financial statement audits, the auditors have a choice about the mix of the evidence obtained from testing controls versus the evidence obtained from substantive procedures. Auditors may decide not to test particular controls in financial statement audits, frequently because it is more efficient to perform substantive procedures.

When the auditors perform an integrated audit, the option of not testing controls for a significant account is not available because controls over all significant accounts should be tested to provide a basis for the opinion on internal control. The auditors should have sufficient evidence to provide an opinion on internal control at the as-of date, ordinarily the last day of the reporting period.

Overall Approach to an Audit of Internal Control

To integrate the internal control audit and the financial statement audit, most auditors plan the internal control audit and then determine the additional testing that is necessary to support an opinion on the financial statements. The internal control audit may be viewed as having the following five stages:

1. Plan the engagement.
2. Use a top-down approach to identify controls to test.
3. Test and evaluate design effectiveness of internal control.
4. Test and evaluate operating effectiveness of internal control.
5. Form an opinion on the effectiveness of internal control over financial reporting.

1. Plan the Engagement

In an integrated audit, the planning of the internal control audit is coordinated with the planning of the financial statement audit. For both audits, the auditors consider matters related to the client's industry, business, and regulatory environment and its internal control, as discussed in Chapter 6. The auditors' procedures to obtain the required knowledge of the client's internal control at the planning stage of the engagement will differ significantly depending upon the nature of the client and the auditors' previous experience with that client. For example, when the auditors have previously performed audits for the client, the auditors begin the integrated audit with more information than in a circumstance in which the client is new.

The auditors should determine whether management has addressed controls over all relevant assertions related to all significant accounts and disclosures in the financial statements. Those controls are of various types and include controls over

- Initiating, authorizing, recording, processing, and reporting significant accounts and disclosures.
- Selecting and applying appropriate accounting principles.
- Fraud, through antifraud programs.
- Various types of significant transactions, including overall company-level controls and information technology general controls, and transactions related to the period-end financial reporting process (e.g., consolidating adjustments, reclassifications, and final adjustments).

2. Use a Top-Down Approach to Identify Controls to Test

As described previously, in an audit of financial statements, the auditors should obtain an understanding of the design of controls in each of the major internal control components—control environment, risk assessment, control activities, information and communication, and monitoring. In an integrated audit, the auditors have this information available through performance of the financial statement audit. The approach used in the internal control audit is “top-down” in the sense that it starts at the top—the financial statements

and entity-level controls—and links the financial statement elements and entity-level controls to significant accounts, relevant assertions, and the major classes of transactions. The goal is to focus on testing those controls that are most important to the auditor's conclusion on internal control, while avoiding those that are less important. The procedures used to obtain an understanding of the relevant controls are the same procedures used to gain this understanding in a financial statement audit. As is the case with financial statement audits, documentation of the understanding is accomplished with flowcharts, checklists, questionnaires, and memos.

3. Test and Evaluate Design Effectiveness

Auditors next evaluate the design of controls—if the design is not effective, then it makes no sense to test whether the controls operate effectively. To test design effectiveness, the auditors identify the company's control objectives and risks in each financial reporting area and then identify relevant controls that satisfy each control objective. Once they have identified the relevant controls, the auditors evaluate the likelihood of control failure, the magnitude of any related misstatement due to such failure, and the degree to which other compensating controls achieve the same control objectives. Then they assess whether the controls, if operating properly, can effectively prevent or detect misstatements that could be material. Procedures performed by the auditors to evaluate design effectiveness include inquiry, observation, additional walk-throughs, inspection of relevant documentation, and specific evaluation of whether the controls are likely to prevent or detect misstatements.

4. Test and Evaluate Operating Effectiveness

Tests of the operating effectiveness of controls are used to determine whether the controls function as designed and whether the individuals performing the controls possess the necessary authority and qualifications. An integrated audit requires the auditors to test controls for all relevant assertions about major accounts. These tests should be designed to provide a high level of assurance that these controls are operating effectively. Generally, the more frequently a control operates, the more often it should be tested, and controls that are more critical should be tested more extensively.

5. Form an Opinion on the Effectiveness of Internal Control

Auditors accumulate their evidence from the previous steps to form an opinion on whether the company maintained, in all material respects, effective internal control over financial reporting. Also, because the audits of internal control and the financial statements are integrated, auditors consider any relevant findings from the audit of the financial statements.

An unqualified audit opinion may be issued when no material weaknesses in internal control have been identified as existing at year-end and when there have been no restrictions on the scope of the auditors' work. If one or more material weaknesses in internal control are found, an adverse opinion should be issued. Scope limitations may result in either a qualified opinion or a disclaimer of opinion, depending on the significance of the limitation.

Internal Control in the Small Company

The preceding discussion of internal control and its consideration by the independent auditors has been presented in terms of large corporations. In the large concern, excellent internal control may be achieved by extensive segregation of duties so that no one person handles a transaction completely from beginning to end. In the very small concern, with only one or two office employees, there is little or no opportunity for division of duties and responsibilities. Consequently, internal control tends to be weak, if not completely absent, unless the owner/manager recognizes its importance and participates in key activities.

Because of the absence of strong internal control in small concerns, the independent auditors must rely much more on substantive procedures of account balances and transactions than is required in larger organizations. Although it is well to recognize that internal control can seldom be strong in a small business, this limitation is no justification for ignoring available forms of control. Auditors can make a valuable contribution to small client companies by encouraging the installation of such controls as are practicable in the circumstances. The following specific practices are almost always capable of use in even the smallest business:

1. Record all cash receipts immediately.
 - a. For over-the-counter collections, use cash registers easily visible to customers. Record register readings daily.
 - b. Prepare a list of all mail remittances immediately upon opening the mail and retain this list for subsequent comparison with bank deposit tickets and entries in the cash receipts journal.
2. Deposit all cash receipts intact daily.
3. Make all payments by serially numbered checks, with the exception of small disbursements from petty cash.
4. Reconcile bank accounts monthly and retain copies of the reconciliations in the files.
5. Use serially numbered sales invoices, purchase orders, and receiving reports.
6. Issue checks to vendors only in payment of approved invoices that have been matched with purchase orders and receiving reports.
7. Balance subsidiary ledger with control accounts at regular intervals and prepare and mail customers' statements monthly.
8. Prepare comparative financial statements monthly in sufficient detail to disclose significant variations in any category of revenue or expense.

Adherence to these basic control practices significantly reduces the risk of material error or fraud going undetected. If the size of the business permits a segregation of the duties of cash handling and record keeping, a fair degree of control can be achieved. If it is necessary that one employee serve as both accounting clerk and cashier, then active participation by the owner in certain key functions is necessary to prevent or detect the concealment of fraud or errors. In a few minutes each day, the owner, even if not trained in accounting, can create a significant amount of internal control by personally (1) reading daily cash register totals, (2) reconciling the bank account monthly, (3) signing all checks and canceling the supporting documents, (4) approving all general journal entries, and (5) critically reviewing comparative monthly statements of revenue and expense.

Chapter Summary

This chapter explained the meaning and significance of internal control, the major components of the client's internal control, and the manner in which auditors consider internal control. To summarize:

1. Internal control is a process, effected by the entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the categories of (a) operations, (b) reporting, and (c) compliance with applicable laws and regulations.
2. The five components of internal control include the control environment, risk assessment, control activities, the accounting information and communication system, and monitoring. The portion of internal control relevant to auditors is that which pertains to the entity's ability to prepare reliable financial statements.
3. Auditor responsibility with respect to internal control includes obtaining an understanding of internal control, assessing the risks of misstatement, and designing further

audit procedures (tests of controls and substantive procedures). The understanding of internal control should include knowledge about the design of relevant controls and whether they have been implemented by the client.

4. In assessing the risks of material misstatement (the “risk assessment”), the auditors consider (a) what can go wrong at the relevant assertion level, (b) whether the risks are of a magnitude that could result in a material misstatement, and (c) the likelihood that the risk could result in a material misstatement. Risks ordinarily exist at the overall financial statement level as well as at the account balance, class of transaction, and disclosure levels.
5. Auditors perform tests of controls when the risk assessment includes an expectation of the operating effectiveness of controls. The risk assessment includes such an expectation when (a) substantive procedures alone do not provide sufficient appropriate audit evidence or (b) auditors wish to reduce the scope of substantive procedures through performance of tests of controls. Auditors will ordinarily wish to reduce the scope of substantive procedures and perform tests of controls in circumstances in which they believe such an approach is cost justified. However, in all circumstances, for relevant assertions some substantive procedures should be performed.
6. Tests of controls address (a) how controls were applied, (b) the consistency with which controls were applied, and (c) by whom or by what means the controls were applied. Tests of controls include inquiries of appropriate client personnel, inspection of documents and reports, observation of the application of controls, and reperformance of controls.
7. Auditors are required to communicate all significant deficiencies and material weaknesses to management and those charged with governance.
8. Large public companies are required to have an integrated audit in accordance with the Sarbanes-Oxley Act of 2002 and Public Company Accounting Oversight Board AS 2201. Integrated audits consist of both an audit of internal control and an audit of the financial statements. The audit report on internal control includes both an opinion on management’s assessment of internal control and the auditors’ own assessment of internal control.

Key Terms Introduced or Emphasized in Chapter 7

As-of date (335) A concept applied to internal control reporting by the Sarbanes-Oxley Act of 2002 and PCAOB AS 2201. The internal control reports of both management and the auditors are as of the final day of the reporting period—the “as-of date.”

Assessed level of control risk (322) The level of control risk used by the auditors in determining the acceptable detection risk for a financial statement assertion and, accordingly, in deciding on the nature, timing, and extent of substantive procedures.

Audit decision aid (328) A standard checklist, form, or computer program that assists auditors in making audit decisions by ensuring that they consider all relevant information or that aids them in weighting and combining the information to make a decision.

Cloud (computing) (329) A model for enabling on-demand user network access to a shared pool of computing resources (e.g., servers, storage, applications, and services), often through a web browser, with minimal effort on the part of the user. For example, an independent service provider may maintain databases for a client that can be accessed in a number of locations by client personnel.

Compensating control (298) A control that reduces the risk that an existing or potential control weakness will result in a failure to meet a control objective (e.g., avoiding misstatements). Compensating controls are ordinarily controls performed to detect, rather than prevent, the original misstatement from occurring.

Complementary controls (298) Controls that function together to achieve the same control objective.

Complementary subservice organization controls (331) Controls applied by a subservice organization that are necessary to achieving one or more service organization controls.

Complementary user entity controls (331) Controls applied by the user entity that the service organization has included within its system that must be implemented to ensure the service organization’s control objectives are accomplished.

Control risk (310) The risk that a material misstatement could occur in a financial statement assertion and not be prevented, or detected and corrected, on a timely basis by internal control.

Controls (296) Policies or procedures established to achieve the control objectives of the organization. Policies indicate what should or should not be done to achieve control, while procedures are actions to implement policies.

Corrective control (297) A control established to remedy control problems (e.g., misstatements) that are discovered through detective controls.

Data analytics (325) Analyses applied to raw data with the purpose of drawing conclusions about relationships. Data analytics is being used by management to get insights into how to improve the effectiveness and efficiency of operations. It is also used as a part of the management review to monitor the performance of other internal controls. Auditors are increasingly using data analytics to improve the effectiveness of certain audit procedures.

Deficiency in internal control (333) A situation in which the design or operation of a control does not allow management or employees, in the normal course of performing their functions, to prevent or detect misstatements on a timely basis. A *deficiency in design* exists when either a control necessary to meet a control objective is missing or the existing control is not designed to operate effectively. A *deficiency in operation* exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.

Detective controls (297) Controls designed to discover control problems soon after they occur.

Direct controls (298) A control that is precise enough to address risks of material misstatement at the assertion level.

Fidelity bonds (306) A form of insurance in which a bonding company agrees to reimburse an employer for losses attributable to theft or embezzlement by bonded employees.

Foreign Corrupt Practices Act (297) Federal legislation prohibiting payments to foreign officials for the purpose of securing business. The act also requires all companies under SEC jurisdiction to maintain a system of internal control providing reasonable assurance that transactions are executed only with the knowledge and authorization of management.

Further audit procedures (310) Substantive procedures for all relevant assertions and tests of controls when the auditors' risk assessment includes an expectation that controls are operating effectively. The auditors perform risk assessment procedures to obtain an understanding of the client and its environment, including internal control. They then conduct a risk assessment and determine the appropriate further audit procedures.

Incompatible duties (305) Assigned duties that place an individual in a position to both perpetrate and conceal errors or fraud in the normal course of job performance.

Indirect control (298) A control that supports direct controls. Although an indirect control is not sufficiently precise to prevent, or detect and correct, misstatements at the assertion level, it is foundational and may have a significant effect on the likelihood that a misstatement will be prevented or detected on a timely basis.

Inherent risk (310) The risk of material misstatement of a financial statement assertion, before considering any related controls.

Integrated audit (335) An audit in which auditors, in addition to an opinion on the financial statements, express an opinion on the effectiveness of a company's internal control over financial reporting, in accordance with PCAOB AS 2201. Public companies with a market capitalization of \$75,000,000 or more are required to undergo integrated audits.

Internal auditors (328) Corporation employees who design and execute audit programs to test the effectiveness and efficiency of all aspects of internal control. The primary objective of internal auditors is to evaluate and improve the effectiveness and efficiency of the various operating units of an organization rather than to express an opinion as to the fairness of financial statements.

Internal control (295) A process, effected by the entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the categories of (1) operations, (2) reporting, and (3) compliance.

Internal control questionnaire (316) One of several methods of describing internal control in audit working papers. Questionnaires are usually designed so that "no" answers prominently identify weaknesses in internal control.

IT general controls (322) Controls over the entity's IT processes that support the continued proper operation of the IT environment, including the continued effective functioning of information-processing controls and the integrity of information in the entity's information system.

Management letter (335) A report to management containing the auditors' recommendations for correcting any deficiencies disclosed by the auditors' consideration of internal control. In addition to providing management with useful information, a management letter also may help limit the auditors' liability in the event a control weakness subsequently results in a loss by the client.

Management review controls (307) Reviews conducted by management of estimates and other kinds of financial information for reasonableness. They often involve the use of significant judgment, knowledge, and experience in comparing recorded amounts with expectations of the reviewers. They often are considered monitoring controls but may relate to any of the other COSO components that have the common characteristic of management review of information to identify misstatements or breakdowns in other controls.

Material weakness (333) A deficiency in internal control over financial reporting (or a combination of deficiencies) such that there is a reasonable possibility that a material misstatement of the company's financial statements will not be prevented or detected on a timely basis.

Organizational structure (299) The division of authority, responsibility, and duties among members of an organization.

Preventive controls (297) Controls that deter control problems before they occur.

Redundant controls (298) Duplicate controls that achieve a control objective.

Relevant assertions (321) An assertion about a class of transactions, account balance, or disclosure that has a reasonable possibility (its "likelihood") of being materially misstated (its "magnitude"). A relevant assertion is said to have "an identified risk of material misstatement." The determination of whether an assertion is a relevant assertion is made before considering any related controls (that is, the determination is based on inherent risk).

Risk assessment procedures (310) Audit procedures performed to obtain an understanding of the client and its environment, including its internal control. Some of the information obtained by performing these procedures may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. Risk assessment procedures include (a) inquiries of management and others within the entity, (b) analytical procedures, and (c) observation and other procedures, including inquiries of others outside the entity.

Risk tolerance (302) The acceptable level of variation in performance relative to the achievement of objectives. For example, a company may expect staff to respond to all customer complaints within 24 hours, but accept that up to 10 percent of complaints receive a response within 36 hours.

Service auditor (329) A practitioner who reports on controls at a service organization. SOC 1, 2, and 3 engagements all involve service auditors.

Service organization (329) An organization that provides services to user entities. For SOC 1 engagements, the services are relevant to a user entity's internal control over financial reporting.

Significant deficiency (333) A deficiency in internal control over financial reporting (or combination of deficiencies) that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

SOC 1 report (329) A service organization report intended to meet the needs of entities that use a service organization (user entities) and the CPAs that audit the user entity's financial statements (user auditors), in evaluating the effect of the controls at the service organization on the user entities' financial statements. The report addresses the service organization's internal control over financial reporting for a particular system. A Type 1 report is issued if the service auditor has not addressed the operating effectiveness of internal control and Type 2 report is issued when operating effectiveness is addressed. The use of these reports is restricted to the management of the service organization, user entities, and user auditors.

SOC 2 report (332) A service organization report intended to meet the needs of a broad range of users that need detailed information and assurance about the controls at a service organization relating to one or more of the AICPA trust services criteria of security, availability, processing integrity, confidentiality, and privacy. As with SOC 1 reports, a Type 1 report is issued if the service auditor has not addressed the operating effectiveness of internal control and a Type 2 report is issued when operating effectiveness is addressed. The use of these reports is restricted to the management of the service organization, customers of the service organization, and other stakeholders.

SOC 3 report (332) A service auditor report based on a SOC 2-type engagement addressing one or more of AICPA trust services criteria of security, availability, processing integrity, confidentiality, or privacy. The reports issued differ from SOC 2 reports in that they are more or less detailed and are designed for general use and distribution. Only Type 2 reports may be issued.

Substantive procedures (tests) (310) Procedures performed by the auditor to detect material misstatements in account balances, classes of transactions, and disclosures.

Suitable criteria (335) Criteria are the standards or benchmarks used to measure and present the subject matter and against which the CPA evaluates the subject matter. Suitable criteria are established or developed by groups composed of experts that follow due process procedures, including exposure of the proposed criteria for public comment. Suitable criteria must have each of the following attributes: objectivity, measurability, completeness, and relevance.

System (the service organization's system) (330) The policies and procedures designed, implemented, and documented by management of the service organization to provide user entities with the services reported upon in the service auditor's report.

System and Organization Controls (SOC) Report (329) A report by the auditors of a Service Organization on the controls over the processing of transactions or data for User Organizations. The report is used by the User Organizations' auditors in their audits.

Systems flowchart (316) A symbolic representation of a system or series of procedures with each procedure shown in sequence. Systems flowcharts are a widely used method of describing internal control in audit working papers.

Tests of controls (310) Procedures performed by the auditor to test the operating effectiveness of controls in preventing or detecting material misstatements at the relevant assertion level. These tests are performed when the auditor's risk assessment includes an expectation of the operating effectiveness of controls, including circumstances in which planned substantive procedures alone do not provide sufficient appropriate audit evidence.

Transaction cycle (313) The sequence of procedures applied by the client in processing a particular type of recurring transaction. The auditors' working paper description of internal control often is organized around the client's major transaction cycles.

Trust services (332) A set of professional attestation and advisory services based on a core set of criteria related to security, availability, processing integrity, confidentiality, or privacy. These criteria are used when evaluating the suitability of the design and operating effectiveness of controls at an entity, division, or operating unit level of an entity. A trust services engagement addresses one or more of the criteria.

Type 1 (SOC) report (330) A service organization report on (1) the fairness of the presentation of management's description of the service organization's system and (2) the suitability of the design. This type of report may not be issued for a SOC 1 engagement. PCAOB AS 2601 refers to such a report as a "report on controls placed in operation."

Type 2 (SOC) report (330) A service organization report on (1) the fairness of the presentation of management's description of the service organization's system, (2) the suitability of the design, and (3) the operating effectiveness of the controls to achieve the related control objectives included in the description throughout a specified period. PCAOB AS 2601 refers to this type of report as a "report on controls placed in operation and tests of operating effectiveness."

User auditor (330) An auditor who audits and reports on the financial statements of a user entity.

User entity (329) An entity that uses the services of a service organization and whose financial statements are being audited. User entities relate to SOC 1 engagements.

Walk-through (320) A procedure in which an auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records, using the same documents and information technology that company personnel use. Walk-through procedures usually include a combination of inquiry, observation, inspection of relevant documentation, and performance of controls.

Written narrative of internal control (316) A written summary of internal control for inclusion in audit working papers. Written narratives are more flexible than questionnaires, but by themselves are practical only for describing relatively small, simple systems.

Review Questions

- 7-1. What is internal control?
- 7-2. Identify the five components of an organization's internal control.
- 7-3. List the principles related to an organization's *control environment*.
- 7-4. How does separation of the record-keeping function from custody of assets contribute to internal control?
- 7-5. Name three factors you consider of greatest importance in protecting a business against losses through embezzlement.
- 7-6. Describe what is meant by the *risk assessment* component of internal control and how it contributes to internal control.

- 7-7. Describe the two types of *monitoring* and provide an example of each.
- 7-8. Identify the four types of *control activities* and describe how each type contributes to effective internal control.
- 7-9. One basic concept of internal control is that no one employee should handle all aspects of a transaction. Assuming that a general category of transactions has been authorized by top management, how many employees (or departments) should participate in each transaction, as a minimum, to achieve strong internal control? Explain in general terms the function of each of these employees.
- 7-10. Compare the objectives of the internal auditors with those of the independent auditors.
- 7-11. What consideration, if any, may external auditors give to the work of a client's internal audit staff?
- 7-12. Describe the relationship between corporate governance and internal control.
- 7-13. What are the purposes of the consideration of internal control required by auditing standards?
- 7-14. A prospective client informs you that all officers and employees of the company are bonded, and he requests that under these circumstances you forgo a consideration of internal control in order to reduce the cost of an audit. Construct a logical reply to this request.
- 7-15. Suggest a number of sources from which you might obtain the information needed to prepare a description of internal control in the audit working papers.
- 7-16. "All experienced auditors would design exactly the same audit plan (program) for a particular audit engagement." Do you agree? Explain.
- 7-17. Under what circumstances are tests of controls *efficient* audit procedures?
- 7-18. How is the auditors' understanding of the client's internal control typically documented in the audit working papers?
- 7-19. What is a management letter? What is the letter's significance?
- 7-20. Comment on the following: The Committee of Sponsoring Organizations has issued frameworks on internal control and on enterprise risk management. A starting point for management of a company just beginning operations is to determine which one of the two to select for use.
- 7-21. You have discussed with the president of Vista Corporation several material weaknesses in internal control that have come to your attention during your audit. At the conclusion of this discussion, the president states that he will personally take steps to remedy these problems and that there is no reason for you to bring these matters to the attention of the board of directors. He explains that he believes the board should deal with major policy decisions and not be burdened with day-to-day management problems. How would you respond to this suggestion? Explain fully.
- 7-22. Distinguish between the two subsections of Section 404 of the Sarbanes-Oxley Act of 2002.
- 7-23. List the five stages of the auditors' overall approach in an audit of internal control performed in accordance with PCAOB requirements.

Questions Requiring Analysis LO 7-2

- 7-24. Management is responsible for designing and maintaining its organization's internal control. In designing internal control, management must consider controls related to each of the five major internal control components: the control environment, risk assessment, the accounting information system, control activities, and monitoring.
 - a. Management is considering controls for the following three *control environment* factors. For each, describe how the factor contributes to effective internal control.
 - (1) Integrity and ethical values.
 - (2) Commitment to competence.
 - (3) Board independence and effective oversight.
 - b. Explain how *risk assessment* contributes to effective internal control, and identify four factors that result in increased financial reporting risk.
 - c. Identify the five major objectives of an *accounting information system*.
 - d. Describe the purpose of the following two types of *control activities*:
 - (1) Performance reviews.
 - (2) Transaction processing.
 - e. Explain the two types of *monitoring* and provide an example of each.

- LO 7-1, 2** 7-25. The definition of internal control as contained in COSO's *Internal Control—Integrated Framework* and the professional standards is quite broad and comprehensive.
- Define *internal control* and its purpose.
 - Explain the major concepts that are included in the definition of internal control.
 - List the five components of internal control.
 - Identify the major limitations of internal control.
- LO 7-2** 7-26. Many companies have implemented COSO's enterprise risk management framework to assist them in managing risks.
- Are public companies required by the SEC to implement COSO's enterprise risk management framework? Explain.
 - Describe two of the components of COSO's enterprise risk management framework.
 - Comment on the accuracy of the following statement: "If management implements COSO's enterprise risk management framework, the organization will be able to avoid all risks." Explain your answer.
- LO 7-3** 7-27. Auditors may restrict substantive procedures based on the results of tests of controls.
- Discuss and contrast the concepts of the planned assessment of control risk and the revised assessment of the risk after tests of controls have been performed.
 - Using internal control for the existence assertion for accounts receivable, provide an example that distinguishes among the concepts discussed in requirement (a) above.
- LO 7-3** 7-28. The auditors' consideration of internal control begins with obtaining an understanding of the client's internal control.
- Describe the remaining stages of the auditors' consideration.
 - Provide examples of audit procedures that are performed at each stage (including the stage of obtaining an understanding).
- LO 7-3, 5** 7-29. Robert Taylor, CPA, is planning the audit of The Neighborhood Store, a local grocery cooperative. Because The Neighborhood Store is a small business operated entirely by part-time volunteer personnel, internal control is weak. Taylor has decided that he will assess control risk at the highest level for all assertions and not restrict audit procedures in any area. Under these circumstances, may Taylor omit the consideration of internal control in this engagement? Explain.
- LO 7-3, 4, 5** 7-30. Adherence to auditing standards requires, among other things, a proper understanding of the existing internal control. The most common approaches to documenting the understanding of internal control include the use of a questionnaire, preparation of a written narrative, preparation of a flowchart, or a combination of these methods.
- Discuss the advantages to CPAs of documenting internal control by using
 - An internal control questionnaire.
 - A written narrative.
 - A flowchart.
 - If they are satisfied that no material weaknesses in internal control exist after completing their description of internal control, is it necessary for the CPAs to conduct tests of controls? Explain.
- LO 7-1** 7-31. Management is responsible for establishing effective internal control for its organization, including measures to prevent, deter, and detect fraud. Appendix 7A describes antifraud programs and measures.
- What are the three major categories of antifraud measures and the measures that should be established under each category?
 - Under the measure of "create a positive workplace environment," provide
 - Two examples of antifraud controls.
 - Two examples of factors that detract from a positive workplace environment.
- (AICPA, adapted)
- LO 7-2, 6** 7-32. Assume that you are auditing the financial statements of Wexler Inc. Wexler's financial statements include a number of significant estimates.
- Describe the desired internal controls over the processes for developing accounting estimates.
 - Describe how the auditors would test the controls over the processes for developing accounting estimates.

- LO 7-1, 2** 7–33. During your first audit of a medium-size manufacturing company, the owner, John Bell, explains that in order to establish clear-cut lines of responsibility for various aspects of the business, he has made one employee responsible for the purchasing, receiving, and storing of merchandise. A second employee has full responsibility for maintenance of accounts receivable records and collections from customers. A third employee is responsible for personnel records, timekeeping, preparation of payrolls, and distribution of payroll checks. Bell asks your opinion concerning this plan of organization. Explain fully the reasons supporting your opinion.
- LO 7-4, 6** 7–34. Internal auditing is a staff function found in virtually every large corporation. The internal audit function is also performed in many smaller companies as a part-time activity of individuals who may or may not be called “internal auditors.” The differences between the audits by external auditors and the work of internal auditors are more basic than is generally recognized.
- Briefly discuss the auditing work performed by the independent public accountant and the internal auditor with regard to
 - Auditing objectives.
 - General nature of auditing work.
 - In conducting their audit, the independent auditors may use the work of the internal auditors. Identify the two ways the external auditors may use the work of the internal auditors.
- LO 7-3, 4** 7–35. Carson Inc. is a private company that manufactures heavy machinery. The company has an active audit committee and board of directors. The audit committee consists of two outside directors and Howard Kress, the company chief financial officer. The audit committee meets quarterly to provide oversight of financial reporting, including reviewing new accounting policies and unusual transactions. Howard Kress personally reviews and approves any related party transactions. Internal audits of operating units are performed by the internal auditor, who reports directly to Laura Howe, the chief operating officer.

The company has a written code of conduct, and employees agree to adhere to the code when they are hired. The company also has a hotline for confidential reporting of unethical behavior that is staffed by the corporate controller. The audit committee reviews summaries of all incidents and investigations performed.

Identify the weaknesses in Carson’s system of corporate governance and provide suggestions for improvement in the system. Organize your answer as follows:

Weakness	Recommended Improvement

Objective Questions

LO 7-1 Select questions are available with Connect
7–36. **Multiple Choice Questions**



Select the best answer for each of the following questions. Explain the reason for your selection.

- A direct control is designed to:
 - Address the same assertion as another control.
 - Prevent or detect misstatements due to error or fraud on a timely basis.
 - Have an indirect effect on the likelihood of misstatement.
 - Detect only processing misstatements within the accounting information system.

LO 7-2

- An entity’s ongoing monitoring activities often include:
 - Periodic audits by internal auditors.
 - The audit of the annual financial statements.
 - Approval of cash disbursements.
 - Management review of weekly performance reports.

LO 7-3

- c. A primary objective of procedures performed to obtain an understanding of internal control is to provide the auditors with:
- (1) Knowledge necessary to determine the nature, timing, and extent of further audit procedures.
 - (2) Audit evidence to use in reducing detection risk.
 - (3) A basis for modifying tests of controls.
 - (4) An evaluation of the consistency of application of management policies.

LO 7-3

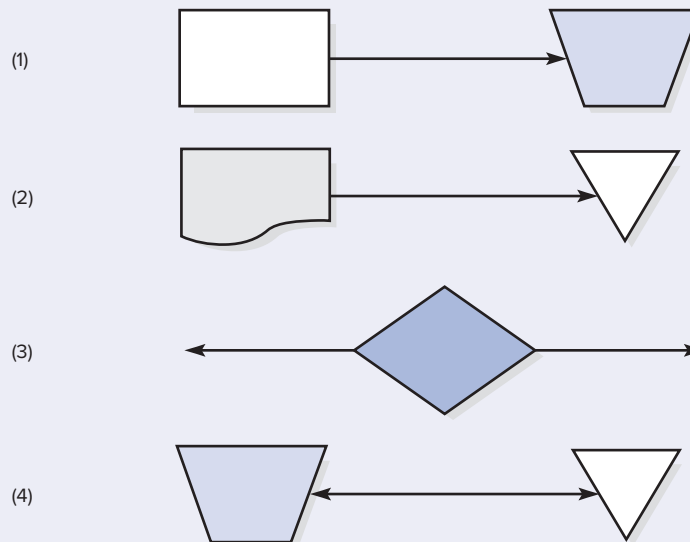
- d. An auditor may compensate for a weakness in internal control by increasing the extent of:
- (1) Tests of controls.
 - (2) Detection risk.
 - (3) Substantive tests of details.
 - (4) Inherent risk.

LO 7-2

- e. Controls over financial reporting are often classified as preventative, detective, or corrective. Which of the following is an example of a detective control?
- (1) Segregation of duties over cash disbursements.
 - (2) Requiring approval of purchase transactions.
 - (3) Preparing bank reconciliations.
 - (4) Maintaining backup copies of key transactions.

LO 7-4

- f. Which of the following symbols indicate that a file has been consulted?



LO 7-4, 6

- g. When a CPA decides that the work performed by internal auditors may have an effect on the nature, timing, and extent of the CPA's procedures, the CPA should consider the competence and objectivity of the internal auditors. Relative to objectivity, the CPA should:
- (1) Consider the organizational level to which the internal auditors report the results of their work.
 - (2) Review the internal auditors' work.
 - (3) Consider the qualifications of the internal audit staff.
 - (4) Review the training program in effect for the internal audit staff.

LO 7-2

- h. Effective internal control in a small company that has an insufficient number of employees to permit proper separation of responsibilities can be improved by:
- (1) Employment of temporary personnel to aid in the separation of duties.
 - (2) Direct participation by the owner in key record-keeping and control activities of the business.
 - (3) Engaging a CPA to perform monthly write-up work.
 - (4) Delegation of full, clear-cut responsibility for a separate major transaction cycle to each employee.

- LO 7-2** *i.* Which of the following is not an advantage of establishing an enterprise risk management system within an organization?
- (1) Reduces operational surprises.
 - (2) Provides integrated responses to multiple risks.
 - (3) Eliminates all risks.
 - (4) Identifies opportunities.
- LO 7-3** *j.* Which of the following is *not* ordinarily a procedure for documenting an auditor's understanding of internal control for planning purposes?
- (1) Checklist.
 - (2) Confirmation.
 - (3) Flowchart.
 - (4) Questionnaire.
- LO 7-8** *k.* To have an adequate basis to issue a management report on internal control under Section 404(a) of the Sarbanes-Oxley Act, management must do all of the following, *except*:
- (1) Establish internal control with no material weakness.
 - (2) Accept responsibility for the effectiveness of internal control.
 - (3) Evaluate the effectiveness of internal control using suitable control criteria.
 - (4) Support the evaluation with sufficient evidence.
- LO 7-8** *l.* When the auditors are performing a first-time internal control audit in accordance with the Sarbanes-Oxley Act and PCAOB standards, they should:
- (1) Modify their report for any significant deficiencies identified.
 - (2) Use a "bottom-up" approach to identify controls to test.
 - (3) Test controls for all significant accounts.
 - (4) Perform a separate assessment of controls over operations.
- LO 7-1** 7–37. You are performing an audit of Western Electronics Corporation and evaluating various controls. Classify the following controls as being primarily preventive (P), detective (D), or corrective (C). Explain your answers.
- a.* Annual physical inventory.
 - b.* Monthly reconciliation of bank accounts.
 - c.* Segregation of duties over purchasing.
 - d.* Supervisory approval of time cards.
 - e.* Dual signatures for checks.
 - f.* Adjustment of perpetual inventory records to physical counts.
 - g.* Management review of budget/actual information.
 - h.* Internal audits of payroll.
- LO 7-2** 7–38. Listed below are controls that have been developed by the management of Centex Manufacturing Co.
1. Management surveys customers about their satisfaction with the company's service.
 2. The human resources department investigates the educational background of prospective employees.
 3. Invoices are reviewed for accuracy before they are mailed to customers.
 4. Management periodically evaluates the threats to preparing reliable financial statements.
 5. The internal auditors periodically evaluate the controls in the various departments of the company.
 6. Management has developed and distributed a *code of conduct*.
 7. Management compares actual performance with budgets and forecasts.
 8. The accounting department uses a manual of accounting policies and procedures.
 9. Entry into the warehouse is strictly controlled by security personnel.
 10. Management has prepared and distributed an organizational chart.
- For each of the controls, identify the internal control component and, if applicable, the subcomponent or principle to which it relates.

- LO 7-1, 2, 3, 4, 6** 7–39. Auditors should have an understanding of the various terms that relate to their consideration of internal control of an organization.

For each term presented below, select the category that most clearly defines or includes the term. The categories may be selected once, more than once, or not at all.

Term	Category
1. Control environment	a. Ongoing and separate evaluations
2. Less severe than a material weakness	b. Documentation
3. Monitoring	c. Relationship of costs and benefits
4. Performance review	d. Significant deficiency
5. Walk-through	e. Risk responses
6. Reasonable assurance	f. Policies and procedures to mitigate risk
7. Flowchart	g. Test of controls
8. Risk assessment	h. Comparison of actual performance to expectations
9. Operating effectiveness	i. Determine implementation
10. Control activities	j. Tone at the top

- LO 7-2, 6** 7–40. For each term in the first column, find the closest definition (or portion of a definition) in the second column. Each definition may be used only once or not at all.

Term	Definition (or Portion)
a. Compensating control	1. A control established to remedy misstatements that are discovered by a detective control.
b. Complementary control	2. A control that functions together with another control to achieve the same control objective.
c. Corrective control	3. A control that reduces the risk that an existing or potential control weakness will result in a failure to meet a control objective.
d. Deficiency in internal control	4. A control that reduces the risk of misstatement by remediating control deficiencies through automated means.
e. Direct control	5. A deficiency in internal control such that there is a reasonable possibility that a material misstatement will not be prevented or detected on a timely basis.
f. Material weakness in internal control	6. A deficiency in internal control that is less severe than a material weakness, but more severe than a significant deficiency.
g. Transaction cycle	7. A situation in which a control does not allow management or employees, in the normal course of performing their functions, to prevent or detect misstatements on a timely basis.
h. Type 1 service auditor report	8. Duplicate controls that achieve a control objective.
i. Walk-through	9. Procedures cycled periodically through the auditors' internal control deviation analysis.
	10. The sequence of procedures applied by the client in processing a particular type of recurring transaction.
	11. A procedure in which an auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records.
	12. A control that is precise enough to address risks of material misstatement at the assertion level.
	13. A report that addresses operating effectiveness of controls.
	14. A report that does not address operating effectiveness of controls.

- LO 7-3** 7–41. Answer the following questions relating to tests of controls and control risk.

- Tests of controls do not address:
 - How controls were applied.
 - How controls were originated.
 - The consistency with which controls were applied.
 - By what means the controls were applied.
- Which of the following is least likely to be a test of controls?
 - Inquiries of client personnel.
 - Inspection of documents.
 - Observation of confirmations.
 - Reperformance of controls.

- c. Tests of controls ordinarily are designed to provide evidence of:
 - (1) Balance correctness.
 - (2) Control implementation.
 - (3) Disclosure adequacy.
 - (4) Operating effectiveness.
- d. The preliminary assessments of control risk are often referred to as:
 - (1) The assessed level of control risk.
 - (2) The planned assessed level of control risk.
 - (3) Control risk.
 - (4) Internal control objectives risk.
- e. At the completion of the audit, the auditors are least likely to know:
 - (1) The assessed level of control risk.
 - (2) The planned assessed level of control risk.
 - (3) Actual control risk.
 - (4) The scope of tests of controls.

LO 7-3 7–42. Answer the following relating to SOC reporting for a service organization.

- a. In the professional standards, SOC stands for
 - (1) Standards of computers.
 - (2) Statements on compliance.
 - (3) System and organization controls.
 - (4) Statutory organization compliance.
- b. A Type 2 SOC for service organizations report is most likely to provide assurance on
 - (1) Compliance with environmental laws.
 - (2) Management's description of its key members.
 - (3) Operating effectiveness of controls.
 - (4) Suitability of design of planned substantive procedures.
- c. To which of the following are SOC 1 reports for service organizations most directly related?
 - (1) Generally accepted service organization accounting standards.
 - (2) Internal control over financial reporting.
 - (3) Internal control over compliance with laws and regulations.
 - (4) Trust services criteria.
- d. Which of the following would be *least* likely to be included in the opinion paragraph of a SOC 1, Type 2 report on a service organization?
 - (1) Management's description fairly presents the XYZ disbursement processing system that was designed and implemented throughout the period January 1, 20X1 to December 31, 20X1.
 - (2) The controls operated effectively to provide reasonable assurance that the control objectives stated in the description were achieved throughout the period January 1, 20X1 to December 31, 20X1.
 - (3) The controls related to the control objectives stated in the description were suitably designed to provide reasonable assurance that the control objectives would be achieved if the controls operated effectively throughout the period January 1, 20X1 to December 31, 20X1.
 - (4) This report's distribution to all interested parties is appropriate.
- e. When considering SOC 1 reporting, a "user auditor" reports on the
 - (1) Compliance of a user organization with service organization requirements.
 - (2) Controls at a service organization.
 - (3) Financial statements of a service organization.
 - (4) Financial statements of an organization that uses the services of a service auditor.

- f. A user auditor has relied upon a SOC 1 service auditor's report relating to its audit of XYZ Company's financial statements. The user auditor's report on XYZ's financial statements should:
- (1) Indicate that no reliance has been placed upon the service auditor's report.
 - (2) Name the service auditor and link it to the service auditor's report.
 - (3) Not refer to the service auditor's report.
 - (4) Refer to the service auditor's report, summarizing its opinion.
- g. When speaking of a SOC 1 engagement, the "carve-out method" is most directly related to complementary
- (1) Indemnification controls.
 - (2) Service provision.
 - (3) Subservice organization controls.
 - (4) User entity controls.
- h. Which of the following is least likely to be included in a SOC 1, Type 1 report?
- (1) The client's description of controls fairly presents the disbursement processing system that was designed and implemented.
 - (2) The controls related to the control objectives stated in the description were suitably designed.
 - (3) The controls operated effectively to provide reasonable assurance that the control objectives stated in the description were achieved.
 - (4) An opinion as of a particular date rather than as of a time interval.

Problems LO 7-3

- 7-43. Microcore Corp., a high-technology company, utilizes the following procedures for recording materials and transferring them to work in process.

- (1) Upon receipt of raw materials by stores, the storekeeper prepares a stock-in report with part numbers and quantities, files the original by date, and sends a copy to accounting.
- (2) The inventory accounting clerk uses the stock-in report to post the perpetual inventory records using standard costs and files the stock-in report by date.
- (3) Raw materials requisitions, which show part number and quantity, are prepared by the manufacturing clerk and approved by the supervisor of manufacturing. A copy of the requisition is sent to accounting, and the original is filed by job order.
- (4) The inventory accounting clerk reviews the requisitions for completeness, transfers the cost from raw materials to work in process, and files the requisitions by date.

Prepare a flowchart that describes the client's system of recording raw materials and transferring them to work in process.

LO 7-1, 3

- 7-44. International Trading Co., a client of your CPA firm, has requested your advice on the following problem. It has three clerical employees who must perform the following functions:

- (1) Maintain general ledger.
- (2) Maintain accounts payable ledger.
- (3) Maintain accounts receivable ledger.
- (4) Maintain cash disbursements journal and prepare checks for signature.
- (5) Issue credit memos on sales returns and allowances.
- (6) Reconcile the bank account.
- (7) Handle and deposit cash receipts.

Assuming that there is no problem as to the ability of any of the employees, the company requests your advice on assigning the above functions to the three employees in such a manner as to achieve the highest degree of internal control. It may be assumed that these employees will perform no other accounting functions than the ones listed and that any accounting functions not listed will be performed by persons other than these three employees.

- a. List four possible unsatisfactory combinations of the above-listed functions.
- b. State how you would recommend distributing the above functions among the three employees. Assume that, with the exception of the nominal jobs of the bank reconciliation and the issuance of credits on returns and allowances, all functions require an equal amount of time.

- LO 7-4** 7-45. Kreton Corporation, your new audit client, processes its sales and cash receipts in the following manner:

(1) *Sales.* Salesclerks prepare sales invoices in triplicate. The original and second copy are presented to the cashier, and the third copy is retained by the sales clerk in the sales book. When the sale is for cash, the customer pays the sales clerk, who presents the money to the cashier with the invoice copies.

A credit sale is approved by the cashier from an approved credit list. After receiving the cash or approving the invoice, the cashier validates the original copy of the sales invoice and gives it to the customer. At the end of each day, the cashier recaps the sales and cash received, files the recap by date, and forwards the cash and the second copy of all sales invoices to the accounts receivable clerk.

The accounts receivable clerk balances the cash received with cash sales invoices and prepares a daily sales summary. Cash sales are posted by the accounts receivable clerk to the cash receipts journal, and the daily sales summary is filed by date. Cash from cash sales is included in the daily bank deposit (preparation of the bank deposit is described with cash receipts in the following section). The accounts receivable clerk posts credit sales invoices to the accounts receivable ledger and then sends all invoices to the inventory control clerk in the sales department.

The inventory clerk posts to the inventory control cards and files the sales invoices numerically.

(2) *Cash receipts.* The mail is opened each morning by a mail clerk in the sales department. The mail clerk prepares a remittance advice (showing customer and amount paid) for each check and forwards the checks and remittance advices to the sales department supervisor. The supervisor reviews the remittance advices and forwards the checks and advices to the accounting department supervisor.

The accounting department supervisor, who also functions as credit manager in approving new credit and all credit limits, reviews all checks for payments on past-due accounts and then gives the checks and remittance advices to the accounts receivable clerk, who arranges the advices in alphabetical order. The remittance advices are posted directly to the accounts receivable ledger cards. The checks are endorsed by stamp and totaled. The total is posted to the cash receipts journal. The remittance advices are filed chronologically.

After receiving the cash from the previous day's cash sales from the cashier, the accounts receivable clerk prepares the daily deposit slip in triplicate. The original and second copy of the deposit slip accompany the bank deposit, and the third copy is filed by date. The bank deposit is sent directly to National Bank.

- a. Prepare a systems flowchart of internal control over sales transactions as described in part (1) above.
- b. Prepare a systems flowchart of internal control over cash receipts as described in part (2) above.

- LO 7-4** 7-46. You have been asked by the board of trustees of a local church to review its accounting procedures. As part of this review, you have prepared the following comments relating to the collections made at weekly services and record keeping for members' pledges and contributions:

- (1) The church's board of trustees has delegated responsibility for financial management and the financial records to the finance committee. This group prepares the annual forecast and approves major disbursements but is not involved in collections or record keeping. No internal or independent audit has been considered necessary in recent years because the same trusted employee has kept church records and served as financial secretary for 15 years.
- (2) The offering at the weekly service is taken by a team of ushers. The head usher counts the offering in the church office following each service. He then places the offering and a notation of the amount counted in the church safe. The next morning the financial secretary opens the safe and recounts the offering. He withholds about \$100 to meet cash expenditures during the coming week and deposits the remainder of the offering intact. In order to facilitate the deposit, members who contribute by check are asked to draw their checks to cash.

- (3) At their request, a few members are furnished prenumbered, predated envelopes in which to insert their weekly contributions. The head usher removes the cash from the envelopes to be counted with the loose cash included in the offering and discards the envelopes. No record is maintained of issuance or return of the envelopes, and the envelope system is not encouraged.
- (4) Each member is asked to prepare a contribution pledge card annually. The pledge is regarded as a moral commitment by the member to contribute a stated weekly amount. Based upon the amounts shown on the pledge cards, the financial secretary furnishes a letter requesting members to support the tax deductibility of their contributions.

Describe the weaknesses and recommend improvements in procedures for:

- Offerings given at weekly services.
- Record keeping for members' pledges and contributions.

Organize your answer sheets as follows:

Weakness	Recommended Improvement

(AICPA, adapted)

In-Class Team Case

LO 7-3,
4, 5

- 7–47. Assume that you have been hired by Ming Lin, CPA, as a new staff assistant. He informs you that his approach to audits has always been to assess control risk at the maximum and perform all the substantive procedures he considers necessary. However, he has recently read an article in *The Journal of Accountancy* that indicates that a more efficient audit may sometimes be achieved by performing some tests of controls and thereby assessing control risk at a lower level. Lin shows you the following table that came from the article:

Inherent Risk	Assessed Level of Control Risk		
	Low	Moderate	Maximum
Low	Highest allowable detection risk (lowest allowable scope of substantive procedures)	High detection risk (low scope of substantive procedures)	Moderate detection risk (moderate scope of substantive procedures)
Moderate	High detection risk (low scope of substantive procedures)	Moderate detection risk (moderate scope of substantive procedures)	Low detection risk (very high scope of substantive procedures)
Maximum	Moderate detection risk (moderate scope of substantive procedures)	Low detection risk (very high scope of substantive procedures)	Lowest detection risk (highest scope of substantive procedures)

Lin understands that the table is only for illustrative purposes and that other “in between” levels of the various risks are possible, but he wants you to use the ones in the table to help him understand the trade-offs between tests of controls and substantive procedures. He understands that these risks would be assessed at the assertion level for the various accounts, but he wants to better understand how the various tests performed in an audit “tie together.” To keep things simple, he says to assume that inherent risk is at the maximum level in all cases.

He has roughed out a table that he wants you to complete for the following three cases:

Case A: Controls, as described by management, appear strong, and Lin wishes to test them to the extent possible. In this case, he realizes that the results of the tests of controls may reveal that the controls are not operating effectively. Accordingly, Case A has three subcases:

- Controls are found to be strong and operate effectively.
- Controls are found to operate moderately effectively.
- Controls, despite management's description, are found to be ineffective.

Case B: Controls, as described by management, appear strong, but Lin wishes to use his old approach of not testing them.

Case C: Controls, as described by management, appear weak.

Required: Fill out the chart using the following reply options.

Question	Reply Options	
1. At what level is the planned assessed level of control risk?	<i>Low</i> <i>Moderate</i> <i>Maximum</i>	
2. Describe the scope of tests of control that will be performed.	<i>None</i> <i>Tests performed</i>	
3. At what level is the assessed level of control risk?	<i>Low</i> <i>Moderate</i> <i>Maximum</i>	
	a. Acceptable Level of Detection Risk	b. Scope of Substantive Procedures
4. What are the (a) acceptable level of detection risk and (b) the resulting scope of substantive procedures?	<i>Lowest</i>	<i>Highest scope</i> —Heavy emphasis on externally generated evidence, performed at year-end, and/or using larger samples
	<i>Low</i>	<i>High scope</i> —Emphasis on externally generated evidence, performed at year-end, and/or using larger samples
	<i>Moderate</i>	<i>Moderate</i> —Balance between externally generated evidence and internally generated evidence performed at year-end or interim period, and/or with moderate sample sizes
	<i>High</i>	<i>Low scope</i> —Emphasis on internally generated evidence, performed at interim dates, and/or using smaller samples
	<i>Highest</i>	<i>Lowest scope</i> —Heavy emphasis on internally generated evidence, performed at interim dates, and/or using smaller samples

	Case A—Controls Appear Strong; Auditor Decides to Test Controls to Extent Possible			Case B—Controls Appear Strong, but Auditor Does Not Test	Case C—Controls Appear Weak
1. At what level is the planned assessed level of control risk? (<i>low; moderate; maximum</i>)					
2. Describe the scope of tests of controls that will be performed. (<i>none; tests performed</i>)					
Results of Tests of Controls	A(1)—Controls Strong (Operating Effectively)	A(2)—Controls Operating Moderately Effectively	A(3)—Controls Operating Ineffectively		
3. At what level is the assessed level of control risk? (<i>low; moderate; maximum</i>)					
4. What is the acceptable level of detection risk? (<i>lowest; low; moderate; high; highest</i>)					
5. Describe the scope (nature, timing, and extent) of substantive procedures. (<i>highest; high; moderate; low; lowest</i>)					

* Inherent risk is assessed at the maximum level; evaluation of controls is based on management's description.

Appendix 7A



Antifraud Programs and Control Measures

The AICPA, with a number of other organizations, prepared a document—*Management Antifraud Programs and Controls: Guidance to Help Prevent, Deter, and Detect Fraud*. That document suggests three categories of measures:

1. Create and maintain a culture of honesty and high ethics.
2. Evaluate the risks of fraud and implement processes, procedures, and controls to mitigate those risks.
3. Develop an appropriate oversight process.

Figure 7.12 summarizes the measures and provides examples.

FIGURE 7.12 Antifraud Measures

1. Create and Maintain a Culture of Honesty and High Ethics	
Measure	Examples of Measure
Set tone at the top	• Establish, communicate, and enforce a corporate code of conduct with employee involvement. • Management's activities should show employees that dishonest or unethical behavior will not be tolerated. • Examples of factors that <i>detract</i> from a positive tone: ▪ Statement by management of an absolute need to meet operating and financial targets. ▪ Establishment of unachievable goals.
Create a positive workplace environment	• Encourage and empower employees to help create a positive workplace. • Allow employees to participate in developing and updating the code of conduct. • Encourage employees and give them the means to communicate concerns about potential violations of the code of conduct without fear of retribution. • Examples of factors that <i>detract</i> from a positive workplace environment: ▪ Top management that does not seem to care about or reward appropriate behavior. ▪ Negative feedback and lack of recognition for job performance. ▪ Perceived inequities in the organization. ▪ Autocratic rather than participative management. ▪ Low organizational loyalty or feelings of ownership. ▪ Unreasonable budget expectations or other financial targets. ▪ Fear of delivering "bad news" to supervisors and/or management. ▪ Less than competitive compensation. ▪ Poor training and promotion opportunities. ▪ Lack of clear organizational responsibilities. ▪ Poor communication practices or methods within the organization.
Hire and promote appropriate employees	• Conduct background investigations on individuals being considered for employment or for promotion to a position of trust. • Thoroughly check a candidate's education, employment history, and personal references. • Train new employees about the entity's values and code of conduct. • Incorporate into regular performance reviews an evaluation of how each individual has contributed to creating an appropriate workplace environment in line with the entity's values and code of conduct. • Periodically objectively evaluate compliance with the entity's values and code of conduct.

Properly train employees	• Training should include information on the company's values and its code of conduct. • Training should include information on the need to communicate certain matters and the manner in which it should be done. • Conduct refresher training. • Require periodic confirmation by employees of their responsibilities.
Discipline	• Expectations about the consequences of committing fraud should be clearly communicated throughout the company. • Appropriate actions should be taken in response to alleged fraud, including: ▪ A thorough investigation of the incident. ▪ Appropriate and consistent actions against violators. ▪ Relevant controls should be assessed and improved. ▪ Communications and training should reinforce the entity's values, code of conduct, and expectations.

2. Evaluate the Risks of Fraud and Implement Processes, Procedures, and Controls to Mitigate Those Risks

Measure	Examples of Measure
Identify and measure fraud risks	• Consider vulnerability of company to fraudulent financial reporting, misappropriation of assets, and corruption (bribery and other such illegal acts). • Consider organizational, industry, and country-specific characteristics that influence the risk of fraud.
Mitigate fraud risks	• Change certain activities (e.g., cease doing business in certain locations). • Change certain processes (e.g., implement lockbox system at a bank instead of receiving payments at the company's various locations).
Implement and monitor controls and other measures	• Evaluate whether controls have been implemented in areas of high risk of fraud. • Implement appropriate oversight measure by board of directors or audit committee to control for risk of management override of controls.

3. Develop an Appropriate Oversight Process

Measure	Examples of Measure
Management	• Oversee activities of employees by implementing and monitoring processes and controls.
Audit committee (or board of directors where no audit committee exists)	• Evaluate management's identification of fraud risks, implementation of antifraud measures, and creation of an appropriate "tone at the top." • Consider likelihood of management override. • Consider communicating with management one or two levels below senior management. • Have an open and candid dialogue with independent auditors on management's risk assessment process and internal control.
Internal auditors	• Determine whether fraud has been committed. • Evaluate fraud risks. • Deter fraud.
Independent auditors	• Assist management and audit committee in assessment of company's process for identifying, assessing, and responding to fraud risks.

Consideration of Internal Control in an Information Technology Environment

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 8-1** Contrast the characteristics of an IT-based system with those of a less sophisticated system.
- LO 8-2** Describe the nature of various types of IT-based systems.
- LO 8-3** Describe the appropriate segregation of duties in an IT environment.
- LO 8-4** Distinguish among general controls, application controls, and user controls in an IT-based system.
- LO 8-5** Explain the manner in which the auditors obtain an understanding of internal control in an IT environment.
- LO 8-6** Discuss the ways in which the auditors may test controls in an IT environment.
- LO 8-7** Describe the nature of automated tools and techniques and the ways that they are used by the auditors.

Historically, in a traditional IT environment, information is processed on a large mainframe computer by a separate information systems department, often using software developed or modified by employees of that department. The other departments of the company, referred to as *user departments*, transmit their data to the information systems department and receive computer-generated reports when processing is complete. However, in today's environment, commercially available software packages often have replaced client-developed software, and many information processing activities have been decentralized. Commercially available computer software varies from applications costing less than \$400 that are basic general ledger systems (e.g., *QuickBooks*) to ERP systems costing into the tens of thousands, and even millions, of dollars (e.g., systems by Microsoft, Oracle, Peoplesoft, and SAP).

For small businesses, computer applications are frequently implemented by personnel within user departments, using **off-the-shelf software** packages. This eliminates the need for the client to employ computer programmers for those applications. A typical small business uses a relatively small computer¹ to run an off-the-shelf general ledger package that provides the basis for its accounting system. Indeed, the computing power of such a computer often is sufficient to meet all the accounting needs of a small business.

A typical large business uses **client/server architecture (IT architecture)** in which a number of "client" computers are connected either to the corporate mainframe system or to another "server" computer. Data are entered and reports are generated at the various locations by user department personnel; the nature of the application determines the combination of processing performed on the client and server computers. A more recent development is the use of cloud computing by companies of all sizes. **Cloud computing** involves the use of IT services that are accessible over the Internet by subscription or lease, from IT service providers, such as Amazon Web Services and Microsoft Azure.

Although IT has created some challenging problems for professional accountants, it also has broadened the horizons of these professionals and expanded the range and value of the services they offer. Technology is more than a tool for performing routine accounting tasks with unprecedented speed and accuracy. It makes possible the development of information that could not have been gathered in the past because of time and cost limitations. When a client maintains accounting records with a complex and sophisticated IT-based system, auditors often find it helpful, and even necessary, to utilize technology in performing many auditing procedures. In addition, these systems make large amounts of data available to the auditors to perform data analytics that can improve the effectiveness and efficiency of audits.

This chapter will consider some of the most significant ways in which auditing work is affected by IT, but it cannot impart extensive technical knowledge. Independent auditors will find additional familiarity with IT to be of ever-increasing value in the accounting profession.

¹ A number of terms have evolved to describe a relatively small computer, including *microcomputer*, *desktop computer*, *personal computer*, *workstation*, *user-operated computer*, and, simply, *computer*. Also, portable versions of these computers include laptops, notebooks, tablets, and various other electronic mobile devices. While some continue to distinguish among these terms, increases in computing power and versatility have blurred many original distinctions.

Nature of IT-Based Systems

LO 8-1

Contrast the characteristics of an IT-based system with those of a less sophisticated system.

Before we consider the impact of IT on the work of the auditors, we need to understand the nature of IT and its capabilities. Auditing standards indicate that the IT environment consists of the IT applications, infrastructure, processes, and personnel that an organization uses to support operations and meet its business strategies. From an audit standpoint, the auditors are primarily concerned with the IT information system, which records, processes, stores, and disseminates information needed for decision making.

Major Components of IT Information System

An (*accounting*) *information system*, as discussed in Chapter 7, is a system that consists of the personnel, processes, and records established to record, process, summarize, and report an entity's transactions and to maintain accountability for the related assets, liabilities, and equity. The exact processes and timing used to record, process, store, and disseminate data and organizational information may vary from system to system, but IT applications, infrastructure, processes, and personnel generally consists of the following major components:

- **Hardware:** The computer and peripheral equipment for input, output, and storage of data.
- **Software:** The programs that tell the computer equipment what to do. Software is of two major types: (1) system software, which controls the operations of the computer itself (e.g., the **operating system**, which schedules tasks, executes applications, and controls connected devices), and (2) **application software**, which is designed to perform specific tasks (e.g., a payroll application).
- **Data:** The inputs and outputs of the IT system. Most accounting IT systems are structured to store data in a database, which is an organized collection of data. Maintaining a **database system** has the advantages of reducing data redundancy and the occurrence of inconsistent data in multiple files. At the other extreme are stand-alone files (e.g., a sales **transaction file** that is not joined or electronically related in any manner to other files).
- **People:** The users and IT system personnel.
- **Processes:** The approach within a company for operating and maintaining the information system.
- **Networks:** Specialized hardware and software that allow different IT devices to connect with each other to share data, software, and other hardware resources.

The information system components used and how the components are arranged determine the *architecture of an information system*. Today, most enterprise accounting information systems have architectures that employ all the major information systems components, but you may encounter a few information systems that do not. Early versions of small business accounting information software such as Quicken and QuickBooks, for example, were originally designed to be installed locally, for example, on a single computer, for a single user. These stand-alone information systems, many of which still exist, do not need the network component to be functional. Before we discuss information systems architectures, and their IT control requirements, it is useful to understand the primary functions of an information system.

Functions of an Information System

Regardless of the information system components used, the architecture employed, or the business task undertaken, information systems perform five fundamental functions, described below.

1. **Capture input.** Inputs are the data needed by the system. An information system must provide a mechanism to capture input. Input can come from many different types of devices, including data entered via a keyboard, a mouse, barcodes, RFID tags, scanning devices, or voice-enabled applications such as Siri and Alexa.

2. **Process.** The transformation of input into output is called *processing*. Performing calculations, validating information, updating records, and tracking raw materials are all examples of processing.
3. **Convey output.** Outputs are the result of processing the data. The most common types of output are hardcopy (printed) reports, output that is displayed electronically (on-screen), and output that is used as input for other information systems.
4. **Collect feedback.** In order to determine whether the system is working as planned, feedback—data about the performance of the system—is collected.
5. **Controls.** **Controls** refer to the policies and procedures that restrict and monitor input, processing, and output to provide reasonable assurance that organizational objectives are being met, including reliable financial reporting.

Characteristics of Various Types of IT-Based Systems

LO 8-2

Describe the nature of various types of IT-based systems.

Information systems are often classified by the business functions they support; for example, *office automation systems*, *transaction processing systems*, *management information systems*, *decision support systems*, *expert systems*, and *enterprise-wide systems*. This chapter focuses on transaction processing systems (e.g., accounting information systems) because they are generally the primary source of data for financial reporting and, hence, the primary type of systems of concern to external auditors. Transaction processing systems are typically those that support routine business activities such as sales, inventory, purchasing, production, accounts payable, accounts receivable, shipping, and payroll by capturing and processing the detailed events or changes associated with regular business activities. These systems range in scope from simple general ledger packages to integrated **enterprise resource planning (ERP) systems**, such as systems by SAP, Oracle, and Microsoft.

Batch vs. Real-Time Processing

The basic functions of information systems (input, processing, output) are typically carried out in one of two ways: in batches (**batch processing**) and in real time (**online processing**). Some transactions are natural candidates for batch processing, including payroll transactions where time records are gathered and processed in “batches” at the end of the pay period. Batch processing does not provide up-to-the-minute, or real-time, transaction information. However, many processes, such as printing payroll checks, benefit from the efficiencies of batch processing. Online processing of other types of transactions leads to greater benefits; airline reservations provide an example of transactions that must be processed in real time. This allows customers an up-to-date view of available seats on each flight. The customer also is free to make a unique reservation because the system has some form of *concurrent update* control that prevents two people from reserving the same seat.

Online systems allow users direct access to data stored in the information system. There are two types of online systems: (1) online transaction processing (OLTP) and (2) online analytical processing (OLAP) systems. **Online transaction processing (OLTP)** systems are used to process various types of accounting and other transactions. When an OLTP system is in use, individual transactions may be entered directly from the originators at remote locations. The transactions may be held in a transaction file and later posted to the records as a batch, or real-time processing may be used. In online, real-time systems, transactions are processed immediately and all accounting records are updated instantaneously. These systems are frequently found in banks and other financial institutions. Online, real-time systems allow a teller at any branch to update a customer’s account immediately by recording deposits or withdrawals on a computer terminal. Similarly, customers are able to transact business directly with the system by inserting an identification card in an automatic teller machine (ATM).

The use of an online real-time system results in significant changes in internal control. Original source documents may not be available to support input into the system, and the overall amount of the hard copy (printed) audit trail may be substantially reduced.

In these systems, essential controls must be programmed into the software. For example, the validity of data should be checked by the computer for completeness and accuracy as transactions are entered into the system.

Online analytical processing (OLAP) involves the use of software technology that enables a user to query the system and conduct various analyses, ordinarily directly from the user's desktop computer. For example, management of an airline may download its online transaction processing reservation database into a **data warehouse**—another database that allows more efficient detailed statistical and graphical analysis of the reservation information. These analyses may be supplemented with the use of consumer and social data to further improve decision making. **Big data** is the name given to the analysis of large amounts of data from varying sources using **data mining**. Management may then use the statistical reports and analyses generated by the OLAP system to make various operating decisions. The data also may be used in conjunction with decision support systems or expert systems. **Decision support systems** combine models and data in an attempt to solve unstructured problems with extensive user involvement. Alternatively, an **expert system** guides decision processes in a well-defined area and facilitates decisions comparable to those of an expert person. As an example, banks may use an expert system to assess the credit risk of potential loan customers.

Information System Architecture

Generally, the architecture of an information system needs to be understood to fully address the IT control risks. Recall that the architecture of an information system refers to the information system components deployed (hardware, software, data, people, procedures, networks) and how these components are arranged.

There are two fundamental types of information system architectures: the single-user, stand-alone architecture and the multi-user, client/server architecture. Our focus is on the client/server architecture because most enterprise information systems today, including accounting information systems, are multi-user, client/server systems.

Client/Server Architecture

The term **client/server architecture** refers to a logical separation of an information system's tasks into *client* and *server* tiers or layers. In its simplest configuration, a client/server architecture logically separates the processing function from the input and output functions of the information system. This configuration would be considered a two-tier client/server system. Physically, the client/server architecture differs from the stand-alone architecture because business applications are installed on computer servers that are specifically designed for faster processing, more storage, and better security than a typical user's stand-alone computer. This allows the user's computer, tablet, or other device (the client device) to be relatively weak in processing power and storage capacity because it is connected to and interacts with the server.

An everyday example of the client/server architecture is a browser (client) such as Chrome, used to access and display web pages from a web server. The server in the client/server architecture is software that is named for the service it provides. For example, an e-mail server serves e-mail; a file server serves files; a web server serves web pages.

Client devices connect to remote servers via wired and wireless private communication networks called **local area networks (LANs)** that generally operate within relatively small geographic areas (typically less than one mile). Clients also can communicate with servers over larger geographic distances using public wired and wireless **wide area networks (WANs)** such as the **Internet**. Wireless WANs also include the cellular networks that mobile devices use for accessing corporate information systems. Because data in an IT network may potentially be altered at any location that can access the system, weak controls at a single location can jeopardize the reliability of the entire networked system. Accordingly, security controls should be established at each location for each device to ensure that data can be changed and accessed only by authorized personnel.

User access that is limited to the corporate LAN generally indicates that the client and server are both on-premises and locally managed in the organization's **intranet**. Off-premises information system architectures typically involve outsourcing arrangements that we will discuss later in this chapter. It is important to understand that on-premises information system architectures may require different IT controls than off-premises architectures.

On-premises accounting information systems and other locally hosted, enterprise information systems have historically been installed on multilayered, or *n-tier*, configurations of the client/server architecture. The three-tier configuration that separates the presentation (client), application processing (business logic), and data management (database) functions was the primary client/server arrangement for most in-house enterprise business systems until *virtualized* IT environments were introduced.

The presentation, processing, and data management tiers of the business applications using an *n-tier* configuration are usually **tightly coupled**, sometimes with static hostnames and IP addresses, for reliability and better performance. Tight coupling, however, makes it more cumbersome for the servers to adapt to changes associated with the information system and the business environment. For example, if the processing requirements of the system increase (e.g., number of transactions goes up), *n-tier* systems often do not easily scale to handle the increased load. Furthermore, when a server fails in an *n-tier* configuration, recovery is often time-consuming and costly. Scalability, business continuity, and system maintenance are important operational business objectives; hence, they are also important IT control considerations. For this reason, organizations small and large have turned to **virtualized client/server infrastructures**.

A virtualized client/server configuration requires the system software to partition a single physical computer server into multiple virtual machines, each capable of running a different operating system and different applications, simultaneously and independently. The economic benefits alone (e.g., fewer physical machines to buy, less energy required) are generally sufficient for businesses to migrate to a virtualized environment for many of their business applications. Virtualized environments are also desirable because the host computer can dynamically allocate computer resources, like **RAM**, to virtual systems being run. Multiple, low-cost virtual servers, called server farms, provide both the redundancy and the scaling capabilities that are relatively difficult to achieve in an *n-tier* client/server environment. It is important for auditors to remember that on-premises, enterprise-level accounting information systems can, and do, run in both *n-tier* and virtualized client/server environments today.

Cloud Computing

The term **cloud computing** refers to the use of off-premises, virtualized IT environments that are owned and managed by IT service providers such as Amazon Web Services (AWS), Salesforce.com, and Microsoft Azure. Access to these off-premises environments is facilitated by both public wired and wireless WANs, including cellular networks. This allows corporate information systems to be accessible from almost anywhere on almost any type of device. Cloud services range in scope from simple access to software housed in the cloud to an entire organization's IT infrastructure being housed in the cloud. Organizations that subscribe to off-premises IT services, somewhere *in the cloud*, are essentially *outsourcing* some, or all, of their IT functions to cloud service providers who own and operate the specialized server farms. A major advantage to cloud computing is that the initial cost of acquisition is generally much lower than an in-house system.

IT control considerations differ depending on the physical location and ownership of the IT infrastructure. In fact, the physical location of an accounting information server is arguably a greater consideration of IT control than its architectural configuration (*n-tier* or virtualized). Information systems that are locally owned and on-premises allow more local control, and are generally more easily audited than those housed by cloud-based

service providers. However, on-premises information systems also may be more vulnerable to employee fraud or misconduct as well as cybercrime than off-premises information systems.

Cloud computing puts company data outside the organization's **firewall**, giving control to the cloud computing vendor. Auditors must be aware that while management can outsource some or all of its IT function to cloud service providers, it cannot outsource its IT control responsibilities. Whatever data touch an organization's financial statements, whether from on-premises or off-premises IT systems, management is ultimately responsible for its accuracy, validity, and security. Hence, cloud computing contracts must include provisions for periodic audits of the provider's information security and processing controls.

End User Computing

When a company implements **end user computing**, the user departments are responsible for the development and execution of certain IT applications. This involves a **decentralized processing system**, in which a user department both generates and uses its own information. For these applications, the information systems department is generally not involved, although certain files may be kept for user departments on centralized servers. End user computing is possible because of the processing power now available with microcomputers. The end user IT system is the opposite of the traditional data processing environment, in which all information needed by users is provided by programs that are purchased or written and tested by the information systems department.

Controls over end user computing are only as good as those instituted by the user departments. For example, if user departments do not adequately test new programs, the reliability of all information in a system may be compromised. As is the case with IT networks, security controls should be established at each location for each device to prevent unauthorized access to the company's data.

Electronic Commerce

The rapid development of **electronic commerce** (e-commerce) continues to have a profound effect on accounting information systems. Electronic commerce involves the electronic processing and transmission of data between customer and client. A variety of activities may be involved, including electronic trading of goods and services, online delivery of digital products, and electronic funds transfer. **Electronic data interchange (EDI)** systems enable a company and its customers or suppliers to use telecommunication links to exchange business data electronically over a private line of communication, as contrasted to the Internet. Source documents, such as invoices, purchase orders, checks, and bills of lading, are replaced with electronic transactions.

Controls over electronic commerce systems include the use of private communication lines, firewalls, terminal controls, data encryption, and antivirus software.

Impact of IT on the Audit Trail

Information technology, whether on-premises or off-premises, may affect the fundamental manner in which transactions are initiated, recorded, processed, and reported. In a manual or mechanical data processing system, an audit trail (transaction trail) of hard-copy paper documentation links individual transactions with the summary figures in the financial statements. For example, individuals may manually record sales orders on paper forms, authorize credit, prepare shipping reports and invoices, record sales in a sales journal, and maintain accounts receivable records. The controls in such a system are also manual, and may include such procedures as approvals, reviews of activities and reconciliations, and follow-up on reconciling items. Alternatively, in an electronic commerce environment, the information system may use automated procedures to initiate, record, process, and report transactions. Records in electronic format may replace paper documents such as sales orders, invoices, shipping documents, and related accounting records. Control in such systems consists of a combination of automated controls and manual controls. In some applications, IT is able to electronically create, update, and delete data



Illustrative Case

The Impact of Blockchain Technology

Innovations in IT will continue to affect the nature of accounting systems and the auditing of these systems. As an example, consider **blockchain**, which is used as the **Bitcoin** trading platform. Blockchain has potential major financial and business implications, including implications for accounting and auditing. Using blockchain technology, transactions may be recorded in a distributed database that maintains a continuously growing list of ordered records called blocks. Each block contains a timestamp and a link to a prior block. Blockchains, once recorded, cannot be deleted or altered. With the use of a blockchain network, the transactions of many entities may be maintained in a secure decentralized database network. Thus, traditional accounting

transactions (e.g., sales and purchases) may be recorded in a secure environment that includes transactions of many organizations, with transactions observable by personnel of all authorized organizations. Ultimately, a blockchain's data could be made available publicly and change the entire nature of financial reporting and auditing. The use of blockchain technology applied to accounting data may ultimately not only modify the nature of accounting systems and related controls, but also provide substantial evidence of the accuracy of recorded transactions without confirmation. However, auditors will still need to obtain evidence that an asset was transferred, the transaction was legal, the transaction did not involve a related party, and there were no side agreements that might affect the valuation of the transaction.

in computer-based records without any visible evidence of a change being made. In addition, the development of telecommunications has created an environment in which data may be altered not only within a specific computer, but by various devices both within and outside the client's organization.

During the early development of IT-based systems, the electronic processing of information led to some concern among accountants that computerized processing would obscure or even eliminate the audit trail. Although it is technically possible to design an information system that would leave no audit trail, such a system would be neither practical nor desirable. An adequate audit trail is necessary to enable management to direct and control the operations of the business, to permit file reconstruction in the event of transmission and processing errors or computer failure, and to accommodate the needs of independent auditors and governmental agencies.

Internal Control in an IT Environment

The discussion of internal control in Chapter 7 stressed the need for a proper division of duties. In a manual information system, no one employee should have complete responsibility for a transaction, and the work of one person should be verified by the work of another handling other aspects of the same transaction. The division of duties in such a manner helps to ensure accurate records and reports and protects the company against losses from fraud or carelessness.

In an IT-based system, work normally divided among many employees may be performed electronically. Consolidation of activities and integration of functions are to be expected because technology can conveniently handle many related aspects of a transaction. For example, a computerized payroll system could maintain personnel files with information on seniority, insurance, and the like; calculate employee pay; distribute labor costs; and prepare payroll checks and payroll records.

Despite the integration of several functions in an IT-based system, the importance of internal control is not in the least diminished. The essential factors described in Chapter 7 for satisfactory internal control remain relevant. Segregation of duties and clearly defined responsibilities continue to be key factors. These traditional control concepts are augmented, however, by controls written into the computer programs and controls built into the computer hardware. In addition to the COSO framework discussed in Chapter 7, other

control frameworks have been developed to assist management in designing and managing an IT environment, such as COBIT 5 developed by the *Information Systems Audit and Control Association* (ISACA). Our discussion of controls in an IT-based environment will include a description of the appropriate segregation of duties, internal auditing of an IT-based system, and IT general and application controls.

Segregation of Duties

LO 8-3

Describe the appropriate segregation of duties in an IT environment.

When apparently incompatible functions are combined in the IT-based system, compensating controls are necessary to prevent improper human intervention with processing. A person with the opportunity to make unauthorized changes in programs or data files is in a position to exploit the concentration of data processing functions in an IT-based system. For example, an IT-based system used to process accounts payable may be designed to approve a vendor's invoice for payment only when that invoice is supported by a purchase order and receiving report. An employee able to make unauthorized changes to data or programs in that system could cause improper payments to be made to specific vendors.

Computer programs and data files cannot be changed without the use of IT equipment. When changes are made, however, evidence of change may be concealed by those with access to the equipment. Thus, the organization of the information systems department should prevent its personnel from having inappropriate access to equipment, programs, or data files. This is accomplished by providing definite lines of authority and responsibility, segregation of functions, and clear definition of duties for each employee in the department. Computer software can be used to enforce the segregation of duties by providing appropriate levels of access based on the employee's position (function) within the organization. In a company that develops and operates its IT applications, the following functions should be appropriately organized:

- *Information systems management.* The information systems manager should supervise the operation of the department and may report to the vice president of finance or administrative services. In many organizations, this individual is called the *chief information officer*.
- *Systems analysts.* Systems analysts are responsible for designing the information system based on the needs of the various user departments.
- *Application programming.* Guided by the specifications provided by the systems analysts, the application programmers design flowcharts of the computer programs required by the system. They then code the required programs in computer language and test the programs with **test data** composed of genuine or dummy records and transactions and perform the necessary debugging. Finally, the application programmers prepare the necessary application documentation, such as the computer operator instructions.
- *Database administration.* The database administrator has the responsibility for planning and administering the company's database. The primary objectives of this individual are to design the database and to control its access and use.
- *Data entry.* Personnel involved with this function prepare and verify input data for processing. Central data entry operators have largely been replaced with new technology. Today, data are typically input via terminals or desktop computers in user departments, scanned directly from source documents or via EDI. Data changes for online real-time systems are normally entered directly into the system by users through telecommunication links so that computer files can be updated immediately.
- *IT operations.* IT operators run and monitor central computers in accordance with standard instructions. The separation of IT operations from programming is an important one from the standpoint of achieving effective internal control. An employee performing both functions has more opportunity to make unauthorized changes in programs.



Illustrative Case

Fraud by Programmers



A programmer for a large bank wrote a program for identifying and listing all overdrawn accounts. Later, he was able to insert a **patch** in the program to cause the computer to ignore overdrafts in his

own account. The programmer was then able to overdraw his bank account at will, without the overdraft coming to management's attention. The fraud was not discovered until there were computer problems and the listing of overdrawn accounts had to be prepared manually.

- *Data control.* The data control group of an information systems department reviews and tests all input procedures, monitors processing, reviews exception reports, handles the reprocessing of exceptions detected by the system, and reviews and distributes all IT output. This group also reviews the log of operator interventions and the library log of program usage. The data control group monitors the computer operator's activities by reviewing the operations log, which records a description of each run, the elapsed time for each run, operator console interventions, machine halts, and files used.
- *Systems programming.* Systems programmers are responsible for troubleshooting the operating system or systems in use, upgrading them when new software releases are provided by the vendor, and working with application systems programs when the applications interact with the operating system in a nonstandard or problematical way. Systems programmers are normally responsible for the proper functioning of the security features built into or added to operating systems.

Other Organizational Controls

Besides segregating functions, the information systems department should cross-train programmers, rotate operator assignments, require mandatory vacations, and obtain adequate fidelity bonds for information systems employees. At least two information systems employees should be present whenever the IT facility is in use. Careful screening policies in hiring information systems personnel are also important to achieve effective internal control.

Computer-Based Fraud



The history of computer-based fraud shows that the person responsible for frauds in many situations set up the system and controlled its modifications.

The number of personnel and the organizational structure of course will determine the extent to which segregation of duties is possible. At a minimum, the function of programming should be separated from the function of controlling data entry, and the function of the computer operator should be segregated from those functions having detailed knowledge or custody of the programs. If one person is permitted to perform duties in several of these functions, internal control is weakened, and the opportunity exists for fraudulent data to be inserted in the system.

Whenever the responsibilities for record keeping and custody of the related assets are combined, the opportunities for an employee to conceal the abstraction of assets are increased. Because record keeping is an essential part of the information system's function, it is highly desirable to limit the access of information systems personnel to company assets. These employees can be considered to have direct access to cash if the information systems department prepares negotiable checks or bank transfers. They also have indirect access to assets if, for example, the computer is used to generate shipping orders authorizing the release of inventory.

Organizational controls are reasonably effective in preventing an individual employee from perpetrating a fraud, but they do not work as well at preventing fraud involving collusion. If key employees or company officers conspire in an effort to commit fraud, controls that rely upon separation of duties can be rendered inoperative.



Illustrative Case

Fraud at Equity Funding



Equity Funding Corporation of America went into bankruptcy after it was discovered that the company's financial statements had been grossly and fraudulently misleading for a period of years. A subsidiary of the company had been manufacturing bogus insurance policies on fictitious persons and then selling these policies to other insurance companies. When the fraud was discovered, Equity Funding's balance sheet included more than \$120 million in fictitious assets, far exceeding the \$75 million net income reported over the 13-year life of the company.

Perhaps the most startling revelation of the Equity Funding scandal was that numerous officers and employees of the company had worked together for years to perpetrate and conceal the fraud. The fictitious transactions had been carefully

integrated into the company's computer-based accounting system. A wide variety of fraudulent supporting documents had been prepared for the sole purpose of deceiving auditors and governmental regulatory agencies. Upon disclosure of the activities, several members of top management were convicted of criminal charges.

The Equity Funding scandal is often described as a computer-based fraud. It was not the use of computers, however, that enabled the company to deceive auditors and government investigators. Rather, the fraudulent activities were successfully concealed for a number of years because of the unprecedented willingness of a large number of company officers and employees to participate in the scheme. Collusion of the magnitude existing at Equity Funding renders internal control ineffective.

Internal Auditing in an IT Environment

While the information systems department is primarily responsible for day-to-day maintenance of the controls for IT processing, the internal auditors are interested in evaluating the overall efficiency and effectiveness of information systems operations and the related controls throughout the company.

The internal auditors should participate in the design of the IT-based system to ensure that the system provides a proper audit trail and includes adequate controls. Once the system becomes operative, internal auditors should review all aspects of the system on a test basis to determine whether prescribed controls are operating as planned. Among other things, the internal auditors perform tests to determine that no changes are being made in the system without proper authorization, programming personnel are functionally separate from IT operating personnel, adequate documentation is being maintained, controls are functioning effectively, and the data control group is performing its assigned functions.

Controls in an IT System

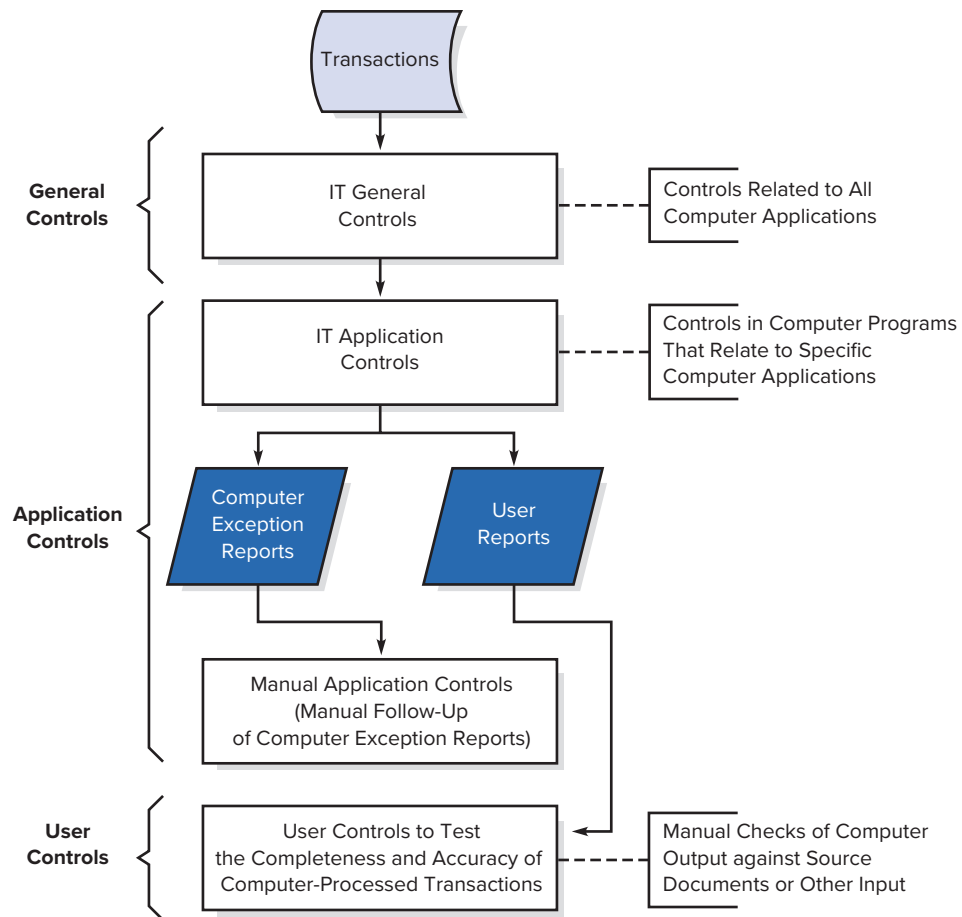
LO 8-4

Distinguish among general controls, application controls, and user controls in an IT-based system.

Information technology controls often are classified as general controls, application controls, and **user controls**. Whereas IT **general controls** ("general IT controls") apply to a number of or to all IT applications, IT **application controls** and user controls (also referred to as **information-processing controls** or **transaction controls**) ordinarily relate to only a specific application, such as the preparation of payroll. IT application controls include both *programmed controls*, which are written into the computer software, and *manual follow-up controls* performed on the exception reports that are generated by the system. User controls are those performed by users to test the accuracy and completeness of IT reports. Figure 8.1 illustrates the relationship among these three types of IT controls.

Besides the two major controls classifications (IT general controls and IT application controls), as discussed in Chapter 7, auditors sometimes refer to controls as either preventive or detective. *Preventive controls*, such as the segregation of duties, are designed to prevent errors, inaccuracy, or fraud before it occurs. *Detective controls*, such as certain internal audit activities, are intended to detect the existence of errors, inaccuracies, or fraud that has already occurred. Preventive and detective controls are often complementary, or work together. For example, acceptable use and access control policies are common examples of preventive controls of a computer system. Periodic review of the access control logs for unusual activity is a detective control measure.

FIGURE 8.1
IT Controls



General Controls

IT general controls support many applications. General controls include controls over (a) system acquisition, development, and maintenance; (b) changes to existing programs and systems; (c) access security; and (d) IT operations controls.

System Acquisition, Development, and Maintenance

These controls ensure that the systems and programs that are developed or customized by the information systems department meet users' needs, are free from errors, and include adequate controls and documentation. Many firms use the *systems development life cycle* approach to develop new systems. This approach is a multiphased, structured approach used to acquire, develop, and maintain information systems. It helps ensure that the organization uses the best practices for developing, testing, and implementing new systems.

Examples of system development controls include policies requiring user involvement in purchase and development processes and appropriate testing of systems and programs before they are implemented. By requiring the information systems department to obtain technical assistance from personnel in other departments, such as the internal auditors, assurance is provided that the hardware and system software being purchased or developed will include appropriate controls.

Another important consideration in developing or customizing new IT-based systems and applications is the preparation of adequate *system documentation*. The purpose of system documentation is to provide an overall description of the IT-based system in the form of system flowcharts and descriptions of the nature of input, operations, and output. It also establishes responsibilities for entering data, performing control tasks, and correcting and reprocessing erroneous data.



Illustrative Case

Breaches at Yahoo!



Cyber attacks present serious risks to all organizations. In 2016, the Internet service company Yahoo! reported two major data breaches of user account information. The first breach occurred in August 2013 and affected more than 1 billion user accounts, and the second occurred in late 2014 and affected more than 500 million accounts. The breaches are considered the largest ever discovered. The hackers obtained

names, e-mail addresses, telephone numbers, security questions and answers, dates of birth, and passwords. After disclosure of the second breach, the market price of Yahoo! stock fell more than 5 percent because of the potential effect on the sale of Yahoo!'s Internet business to Verizon. In addition, it was revealed that the SEC had undertaken an investigation as to whether Yahoo!'s management should have notified investors sooner about the massive data breaches.

Changes to Existing Programs

Frequently, changes in programs are suggested by users who have noted various difficulties associated with a processing system. These suggestions are generally documented in a **change request log**, which is used to initiate various program changes.

The process of changing programs and systems must be carefully controlled. There should be appropriate reviews of all changes, and the modified program should be thoroughly tested before it is implemented. In addition, all changes should be adequately documented, showing what was changed and why.

Access Security

The increasing volume of digital information and the accessibility afforded by information systems, wireless devices, and computer networks, particularly the Internet, have elevated the security risks. Every IT-based system should have adequate security controls to safeguard equipment, files, and programs against loss, damage, and access by unauthorized personnel. Digital information is only as secure as the people, the information systems, and the computer networks that access, store, and distribute the information. Information and systems that are presumed to be private and secure seem to be breached regularly, exposing business and sensitive personal information to risks of compromise, alteration, and destruction. Organizations should consider using information security standards, such as ISO 27002, in evaluating their systems.

To help ensure appropriate segregation of duties and to safeguard data, the IT system should allow employee access privileges on a basis strictly consistent with the employee's job function. As an example, warehouse personnel should not have the ability to alter the accounting records of inventory stored in the warehouse.

Physical Controls Physical controls are necessary to protect IT equipment against sabotage, fire, and water damage. The best way to prevent deliberate damage is to limit access to authorized personnel only. Visitors to a centralized information systems facility should be accompanied by authorized personnel. Information systems personnel should be carefully screened before being hired, and management should always be alert to the possibility of damage by a disgruntled employee. Frequently, the IT facility is kept in an inconspicuous location. The facility should have no windows and few doors; entrances should be controlled by guards, biometric identifiers, or smart ID cards. In addition, the computer room should have a fire-suppression system, a cooling system, and emergency power, and it should be above likely flood levels.

Infrastructure Controls The first level of defense for the security of information and systems is an effective technology infrastructure that includes encryption, certification, and firewalls.

Encryption is one of the most common techniques employed today to protect the privacy and integrity of digital information and to ensure private, secure communication. Encryption refers to the process of transforming original information into something

unreadable using a secret, reversible technique or algorithm. A commonly used form of encryption, called public-key encryption, uses one key for encryption and another related, but mathematically obscure, key for decryption. Using this technique, an organization may distribute a public key to anyone with whom it wishes to communicate.

Internet transactions are secured through a system of public-key encryption and **Certificate Authorities** who verify the identities of individuals or servers and create digital certificates to ensure secure communication. Conceptually, a digital certificate is similar to your signature card on file at your bank. If you write someone a check, that individual can take it to your bank and cash it if the signature on the check matches the signature card. In the same way, with a digital certificate, an organization may be assured of the identity of the party with whom it is communicating.

A **firewall** is used to prevent unauthorized access to a computer or private network. A firewall can be implemented through hardware, software, or a combination of both. Small office environments with an Internet connection often rely only on hardware that integrates router and firewall technology into a single device. Large organizations typically use network firewalls to prevent unauthorized users from accessing the organization's network. All messages entering or leaving the organization's network pass through the firewall, which examines each message and blocks those that do not meet the specified security criteria.

An information security breach is often the result of *unauthorized access and use* of an organization's information, such as personal information about the organization's customers. Many organizations now require employees to sign a formal *Acceptable Use Policy* before they are granted access to organizational information assets. Employees also should be adequately trained on system security.

Acceptable use agreements and training are important for communicating the rules and regulations associated with information resources. However, these agreements provide little deterrent for a cyber criminal and those determined to gain access to personally identifiable information and other sensitive organization information. The next level of information security involves the use of *access controls*, which are hardware and software mechanisms implemented to further enhance security.

Authentication Authentication refers to the process of verifying the identity of a person accessing a system or data. The most common authentication techniques for information security today involve the following three types of identifiers:

- Something a person knows, such as usernames, passwords, and PINs. A combination of username and password is the most common form of authentication used today.
- Something a person is (biometric identifiers), such as fingerprints and retinal scans. *Biometric identifiers* are becoming more commonly used to secure small, handheld devices and high-risk physical locations.
- Something a person possesses, such as an identity card, token, or smart card. *Smart cards* typically store identification information that is accessible by a reader and are often used in conjunction with passwords to secure locations or gain access to account information. Token-based authentication is an increasingly popular way to securely access remote systems and servers. Tokens are typically small, handheld devices that either have a small display screen or plug directly into the USB port of a computer.

Most organizations employ two-factor authentication, which involves the use of two forms of authentication. As an example, logging on to a system with a personal computer may require input of the username and a password and a biometric identifier or a PIN sent to the user's cell phone.

It is important for employees to secure their authentication information and items against unauthorized use. Passwords should be unpredictable, complex, and changed periodically. When employees leave the organization, the employee should be required to relinquish identity cards or tokens and company-owned laptops or other electronic devices that may contain sensitive information. In addition, the ex-employee's access to the system should be immediately deactivated.

IT Operations Controls

To minimize the opportunity for unauthorized changes in programs, the computer operators should have access only to the **operations manual** that contains the instructions for processing programs, and not detailed program documentation. The operations manual should be sufficient to allow operators to solve routine operational problems and to train new operators.

Careful job scheduling and monitoring help control the possibility of inappropriate program modification. The data control group should monitor the computer operator's activities by reviewing the operations log, which records a description of each run, the elapsed time for each run, operator console interventions, machine halts, and files used.

Servers can be damaged by exposure to magnetic fields or excessive heat. It is also possible that a cyber criminal may gain access to the organization's system and destroy the data using **malware** or hold it ransom using **ransomware**. As a precaution against such events, backup copies should be frequently made of all files and programs. Backup files should be maintained at separate locations, for example, the cloud.

Application Controls

IT application controls apply to the input, processing, and output of individual applications. These controls begin with requirements for proper authorization of the transactions to be processed. When transaction data are originally recorded on **hard-copy** source documents, such as sales orders, authorization may be indicated by the appropriate person initialing the document. When transaction data are entered directly into the system by the designated department or individual, terminals should be restricted to authorized personnel through the use of appropriate authentication techniques, for example, usernames and passwords. The **operating system** should maintain a log of activity at each terminal to be reviewed by the system's control group for evidence of unauthorized use.

Application controls may be classified as programmed controls or manual follow-up controls.

Programmed Controls

Programmed controls are those written into computer programs that help ensure the accuracy of IT input and processing. A major aspect of programmed controls is *input validation (edit) checks* that are performed on the data being entered. Examples of these controls include

- *Limit test.* A test of the reasonableness of a field of data, using a predetermined upper and/or lower limit.
- *Validity test.* A comparison of data (for example, employee, vendor, and other codes) against a **master file** or table for accuracy.
- *Allowed character test.* A test of whether the data inputted is of the proper type, for example, numeric.
- *Missing data test.* A test to determine that all required fields in a set of input data contain entries.
- *Self-checking number.* A self-checking number contains redundant information, such as the last two digits being a mathematical combination of the others, thus permitting a check for accuracy.

Input validation checks increase the accuracy of input data by rejecting any data that fail to meet an edit check and by informing the user that revised information is needed. The data also can be tested for completeness. For example, the program can determine whether all required fields in an on-screen form have been completed.

Input controls in batch IT systems are used to determine that no data are lost or added to the batch. The sequence of serial numbers or source documents composing each batch

should be accounted for. In addition, the following controls help ensure the accuracy and completeness of batch processing:

- *Item (or record) count.* An item count is a count of the number of items or transactions being input in a given batch.
- *Control total.* A control total is the total of one field of information for all items in a batch. An example would be total sales for a batch of sales orders.
- *Hash total.* A hash total is a total of one field of information for all items in a batch, used in the same manner as a control total. The difference between a hash total and a control total is that a hash total has no intrinsic meaning. An example of a hash total would be the sum of the employee Social Security numbers being input for payroll processing.

A comparison of totals may be performed either by the hardware or manually by the control group.

Processing controls are designed to ensure the reliability and accuracy of IT processing. A number of the input controls described above are programmed as processing controls, including limit tests, validity tests, self-checking numbers, item counts, and control and hash totals.

Manual Follow-Up Controls

Most manual follow-up controls consist of review and analysis of outputs that have been generated in the form of *exception reports*. For example, a report might be produced that lists transactions where information is missing or inconsistent with other information or appears to be invalid for some other reason.

The effectiveness of manual follow-up controls depends upon the effectiveness of the programmed controls that produce the exception reports. Thus, if a program does not generate an exception for an improper transaction, no manual follow-up is likely because the transaction is not included in the exception report. In addition, problems will persist if user departments do not take actions to correct transactions listed on exception reports, or if they fail to analyze the underlying causes for the exceptions.

User Controls

User controls are designed to test the completeness and accuracy of IT-processed transactions. These controls are generally designed to ensure the reliability of IT output (summary reports and transaction data). Reconciliation of control totals generated by the system to the totals developed at the input phase is an important aspect of user controls. In some systems, user departments may appraise the reliability of output from the information systems department by extensive review and testing. For example, sales invoices generated by the IT-based system may be tested for clerical accuracy and pricing by an accounting clerk. Although these user controls can be very effective, it is generally more efficient to implement effective application controls and have users merely test the overall reasonableness of the output.

Controls When Using Cloud Computing

As discussed previously, management is responsible for the adequacy of internal controls even when much of the system is administered by a cloud service provider. In such cases, management should coordinate and integrate the organization's controls with those established by the service provider. For example, the organization needs to implement access and authentication procedures to prevent unauthorized access to programs and data in the cloud. Appropriate controls should be established to check the accuracy and completeness of processing by the cloud service provider. In addition, appropriate segregation of duties should be implemented, as described earlier in this chapter.

Control in Decentralized and Single Workstation Environments

Decentralized processing systems generally involve the use of one or more user operated workstations to process data. Similarly, a single workstation may be used by a relatively small company to process data. While decentralized and single **workstation** systems have a smaller capacity and are slower at processing data than mainframe computers, they have the advantage of giving company employees direct access to a computer

system without the constraints of **centralized processing systems**. For that reason, even audit clients with sophisticated centralized computer systems are likely to use workstations for a variety of onsite record-keeping functions.

In decentralized environments, computers are located in users' departments and often are operated by user personnel who have little or no computer training. Processing usually is performed with commercial off-the-shelf packages. For secondary storage, workstations use hard disk or solid-state drives where programs are stored. High-volume servers or cloud service providers are used as backup for the workstation.

Internal control over **user operated computers** is enhanced when computer processing procedures are documented and users are well trained. To ensure that the client can reconstruct financial records, backup should be performed frequently. Because the computers are located in user departments, there is a greater risk of use by unauthorized personnel. Therefore, the computers should be programmed to require user authentication to gain access to application menus that control specific programs and files. Users should have access to data and processes consistent with their rank and job functions. In addition, management should consider installing hardware controls, such as a locking on/off switch on the computer to prevent unauthorized use of the machine after business hours, or keeping critical programs on removable hard drives that can be locked up when not in use. The auditors are concerned with these and other controls over user operated computers when the information processed by them may affect the reliability of the information in the client's financial statements.

A risk in the use of user operated (decentralized) computers is the possibility of software viruses. A **software virus** is a program that has the ability to attach itself to a legitimate program and modify other programs and systems. Viruses can cause loss of data and programs. Controls that help to prevent computer viruses include

- Obtaining software only from reputable sources.
- Prohibiting the use of unauthorized programs.
- Prohibiting the downloading of programs from sources such as computer bulletin boards.
- Using antivirus and malware software.

Monitoring in an IT Environment

As discussed in Chapter 7, monitoring is the process used to assess internal control performance over time. An advantage of IT is the ability to use **automated tools and techniques** to continuously monitor internal control performance. Technology can be used to identify all transactions or items that meet the defined criteria. If the criteria are established properly, the technology may effectively identify transactions or items that were not subjected to appropriate controls or, otherwise, need management attention. For example, continuous monitoring may be used to identify transactions or items that are unauthorized, suspicious, or otherwise unusual in nature. Continuous monitoring may be very effective at detecting potential financial statement misstatements, and may reduce the need for other controls.

The Auditors' Consideration of Internal Control in an IT Environment

LO 8-5

Explain the manner in which the auditors obtain an understanding of internal control in an IT environment.

Recall from Chapter 6 that the overall approach that auditors use in a financial statement audit includes

1. Plan the audit.
2. Obtain an understanding of the client and its environment, including internal control.
3. Assess the risks of material misstatement and design further audit procedures.
4. Perform further audit procedures.
5. Complete the audit.
6. Form an opinion and issue the audit report.

As is the case for manual controls, the auditors' consideration of IT controls relates most directly to stages 2 through 4. Recall from Chapters 5 through 7 that the auditors first obtain an understanding of the client and its environment (stage 2) and then use this understanding to assess risk and design further audit procedures (stage 3). Further audit procedures, consisting of tests of controls (as appropriate) and substantive procedures, are then performed (stage 4).

Obtaining an Understanding of IT-Based System Controls

Both the PCAOB (AS 2110) and AICPA (AU-C 315) risk assessment requirements require consideration of manual and IT systems in obtaining an understanding of the client and in assessing the risks of material misstatement. The AICPA auditing standards explicitly require auditors to consider IT applications and other aspects of the IT environment that present **risks arising from the use of IT** that may lead to material misstatements. This requirement includes obtaining an understanding and evaluating both the design and implementation of related controls. Such risks are likely to be higher when IT use includes interfaced applications and applications that automatically initiate transactions as compared to low-volume, stand-alone applications that are supported by hard copy documents.

Specialized skills may be needed to understand internal control or to design effective audit tests for clients with IT-based systems. Therefore, training and education about IT systems and controls are an important part of the professional development programs of many CPA firms. Some CPA firms have trained *IT specialists* who act as consultants to the firm's other auditors on audits that involve particularly complex IT systems. Other CPA firms rely on outside consultants to provide this assistance on complex engagements. In either case, the auditor in charge of the engagement should have sufficient IT-related knowledge to review the adequacy of the procedures performed by the specialist. The results of the specialist's procedures should be considered when planning the nature, timing, and extent of other audit procedures.

When an organization outsources a portion of its systems (e.g., using a cloud-based system), the auditors need to obtain an understanding of the cloud vendor's controls. This understanding may be obtained by requesting a copy of the vendor's service auditor report. As described in Chapter 7, these reports typically provide a description of the vendor's relevant controls and the results of certain tests of the controls.

Documenting IT-Based System Controls

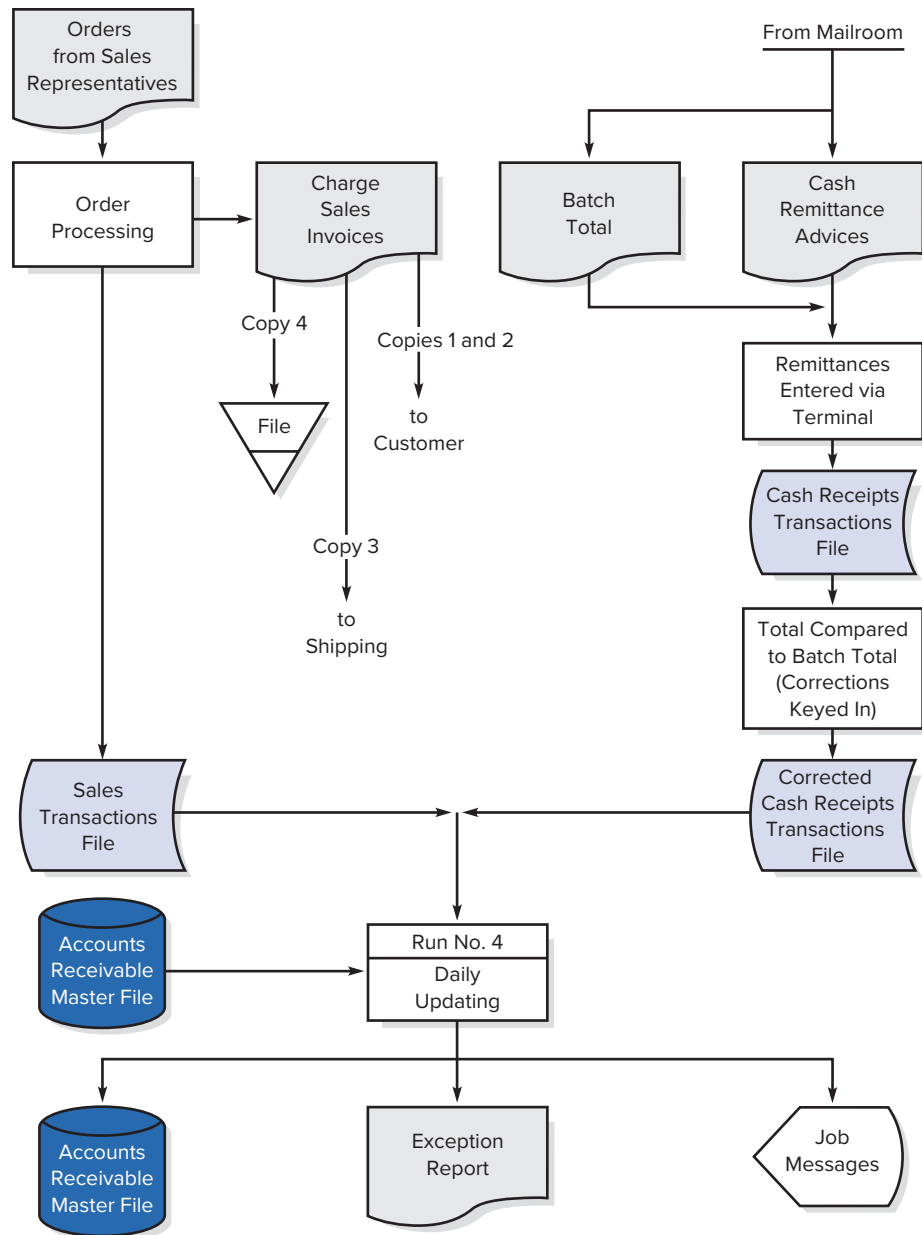
The auditors' documentation of the client's IT-based system varies depending on the complexity of the system. However, IT-based systems are usually documented by the use of systems flowcharts or specially designed internal control questionnaires.

Systems Flowcharts As explained in Chapter 7, *systems flowcharts* are a commonly used technique for documenting internal control in audit working papers. An advantage of using systems flowcharts is that the information systems department should have them available as part of the standard documentation.

An illustration of a systems flowchart for sales, accounts receivable, and cash receipts appears in Figure 8.2. The following description of the illustrated procedures and IT systems should be helpful in studying the illustrated flowchart.

1. Orders are received from sales representatives, and sales invoices are printed. A computer file of sales transactions is generated as a by-product of order processing and sales invoice preparation. Two copies of the invoices are mailed to the customer, one copy is sent to the shipping department, and one copy is filed offline.
2. Individual cash remittances from customers are received from the mailroom and verified to a batch total, which is also received from the mailroom. These remittances are entered via terminals to a computer file of cash receipts transactions, with the total input being compared to the batch total. After the auditors compare batch totals, any necessary corrections are made to the transactions file.

FIGURE 8.2
Systems Flowchart



3. The accounts receivable master file is updated by processing both the sales transactions file and the cash receipts transactions file. A by-product of the updating of the accounts receivable master file is an exception report for the run and a printout (on an online terminal) of any job messages.

The client's documentation of IT processing activities usually includes program flowcharts as well as systems flowcharts. Program flowcharts illustrate the detailed logic of specific computer programs. In some circumstances, auditors may use program flowcharts to obtain an understanding of the program controls contained in specific IT applications. This, however, involves careful consideration of the detailed logic of the program, is extremely time-consuming, and generally exceeds the level of knowledge required to plan the audit.

Internal Control Questionnaires for IT-Based Systems As an alternative or supplement to systems flowcharts, the auditor may decide to document an IT-based system with specialized questionnaires. A specialized IT internal control questionnaire for the general controls over access to the IT-based system is illustrated in Figure 8.3.

Assessing the Risks of Material Misstatement

Recall from Chapters 5 through 7 (particularly Chapter 6) that during the risk assessment stage of an audit, the auditors assess the risks of material misstatement by using the audit evidence obtained on the client and its environment, including its internal control. The overall approach (summarized) is

- Identify risks of misstatement by performing risk assessment procedures.
- Assess identified risks of material misstatement at the financial statement level.
- Assess identified risks of material misstatement at the assertion level.
- Design further audit procedures (tests of controls and substantive procedures) in response to the identified risks of material misstatement.

FIGURE 8.3 Internal Control Questionnaire

Access to IT System Resources		KP 8/15/X1
	Yes, No, N/A	Comments
1. Does the company have documented policies and procedures for IT security?	No	No written policies.
2. Are there adequate physical controls to restrict access to the IT facilities to authorized individuals?	Yes	Card key access. Visitors are accompanied by authorized personnel.
3. Are programmers restricted from access to application programs, job control language, and live data files?	Yes	The operating system security program restricts access to other programs and data.
4. Has a test library procedure been established so that programming is not performed using live data files and applicable programs?	Yes	Test data files are used for testing programs.
5. Are operators restricted from access to source programs?	Yes	Source programs cannot be accessed by operators.
6. Are utility programs that can alter data without any audit trail adequately controlled and their use logged for subsequent management reviews?	Yes	Access to utility programs is restricted by the security program.
7. Is there terminal access control software that restricts who can access the system, what programs can be used, and what files the user and/or program can access and alter?	Yes	Access restricted by use of passwords.
8. Does terminal access control rely on passwords or other identification/validation processes to control access to the system?	Yes	Unattended terminals log off automatically after 10 minutes of inactivity.
9. Are passwords controlled to ensure that they are confidential, unique, and updated to reflect needed changes on a timely basis?	Yes	Policies restrict access to passwords and require a change every 3 months. Procedures require user accounts and passwords to be removed when employees leave the company.
10. Are all significant events (security violations, use of critical software, or system commands, etc.) logged and promptly investigated by appropriate management personnel?	Yes	Reviewed by security manager.

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The nature of the client's IT system will affect the risks that management must confront in designing controls for the system. As an example, if the client employs end user computing, management should design and implement appropriate controls for that aspect of the IT system. Figure 8.4 illustrates typical risks related to IT system areas and controls that are often implemented for those areas. In assessing the risks of material misstatement, the auditors should identify these risks and evaluate the effectiveness of the related controls in mitigating them.

In assessing control risk, the auditors should carefully consider changes or conditions that might inadvertently affect control risk. As an example, the recent COVID-19 pandemic caused many companies to modify the way they conduct business. Many employees were required to work at home, altering control risks, such as increased cyber risk from employees accessing programs and data from home, and increased risk related to monitoring controls that rely upon the observation of employees by supervisors.

Assessing the risks of material misstatement involves evaluating the effectiveness of a client's automated and manual controls. In this section, we focus on tests of controls over IT-based systems.

Determining the Approach to the Audit

LO 8-6

Discuss the ways in which the auditors may test controls in an IT environment.

After obtaining an understanding of the client's internal control, the auditors are in a position to determine an effective and efficient approach to the audit. When the client's IT-based system is relatively simple and produces hard-copy documents and records, the auditors may decide that it is efficient to bypass extensive testing of IT processing. Using this approach, the auditors will test transactions manually, generally emphasizing inputs into the IT-based system and its outputs. If the results of these tests are satisfactory, the auditors will assume that the client's system is processing data properly. This technique is called *auditing around the computer* because the auditors bypass the computer rather than performing tests of the operating effectiveness of IT controls.

While auditing around the computer can be an effective approach in limited circumstances, it is unacceptable if the reason for its use is merely the auditors' lack of understanding of the client's IT processing activities. Recall from earlier in this chapter the AICPA requirement that auditors understand the related risks of material misstatement arising from the use of IT and the organization's general IT controls. The approach of auditing around the computer often relies upon substantive procedures to reduce detection

FIGURE 8.4 Assessing the Risks of Various Types of IT

Information Technology	Typical Risks	Selected Controls
Computer operations	Unauthorized access; destruction of infrastructure or data	Physical controls; segregation of duties; program and user controls
Computer programs	Unauthorized changes	Controls over access; segregation of duties; testing of programs; backup copies
Data files, including databases	Unauthorized changes; destruction of data	Controls over access; segregation of duties; backup copies; program and user controls
IT networks and electronic commerce	Unauthorized changes to data or programs; introduction of unauthorized data or programs; unauthorized interception or viewing of data; viruses	Firewalls; physical control over terminals; password systems; data encryption; antivirus software
End user computing (user operated computers)	Unauthorized access to data or programs	Password systems; physical controls over terminals; testing of user programs and applications

risk to an acceptable level. Such an approach is only appropriate when an auditor has met the professional standards related to IT and satisfied that such substantive procedures will be effective in reducing detection risk to an acceptable level.

Also, recall from Chapter 7 that in auditing control activities (automated or manual), the auditors address the design and implementation of those that affect the risks of material misstatement, including

- Controls over journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.
- Controls for which the auditor plans to test operating effectiveness in determining the nature, timing, and extent of substantive procedures.
- Controls that address a risk that is determined to be a significant risk.
- Other controls that will enable the auditor to assess the risks of material misstatement at the assertion level and to design further audit procedures.

When a significant amount of information supporting the financial statements is in electronic form, obtaining the necessary evidence relating to the controls indicated above may be problematic. Thus, the auditors may determine that it is not possible to design effective substantive procedures that by themselves provide sufficient evidence that the financial statements are not materially misstated. Examples of such situations include the following:

- A client conducts business using information technology to initiate orders for goods using predetermined decision rules and pays for the related payables using system-generated information regarding the receipt of goods.
- A client provides electronic services to its customers (e.g., an Internet service provider or a telephone company) and uses the computer to log services provided to users, initiate billing, process billing, and record such amounts.

In the vast majority of situations, auditors will decide that it is necessary to test controls in addition to performing substantive procedures.

Tests of Controls

The purpose of tests of controls is to provide reasonable assurance that the controls described in the audit working papers are actually effectively operating as designed. Regardless of the nature of the client's system, auditors should perform tests of those controls that—based on the auditors' risk assessment—are presumed to be operating effectively. The nature of the IT-based system may, however, affect the specific procedures employed by the auditors in testing the controls that affect the risks of material misstatement. Also, as is discussed further in Chapters 10 through 15, use of data analytical approaches may increase the effectiveness and efficiency of tests of controls.

Procedures to Test General Controls

The auditors will usually begin their consideration of IT controls by testing general controls that affect the risks of material misstatement. This is an efficient approach because the effectiveness of specific application controls is dependent on the existence of effective general controls over all IT activities. The auditors, for example, would get little audit evidence from testing programmed controls in a payroll program in an environment where programmers can easily make unauthorized changes in any program. In the absence of controls over program modification, the auditors have no evidence that the program being tested is identical to the one used to process data during the year. Such weaknesses would limit (or eliminate) the auditors' ability to rely on application controls and require them to rely upon substantive procedures to appropriately reduce the related risks of material misstatement.

Tests of the effectiveness of controls for development of new programs and systems may include making inquiries of personnel, reviewing documentation of development



Illustrative Case

Evolution of Auditing Around the Computer

IT processing, originally referred to as EDP (electronic data processing), began in the 1950s with the introduction of large mainframe computers. In the early years of IT processing, few individuals had related skills and auditors generally used an approach of “auditing around the computer.” The approach generally involved ignoring IT control and processing issues and auditing inputs into the computer and resulting outputs, thus obtaining assurance that the processing had been proper.

Throughout the subsequent years, IT processing has increasingly been integrated into, and indeed become, a very major part of client accounting systems essential to the preparation of financial statements. As time has passed, professional auditing materials have been developed that assist auditors with understanding IT processing and how it can be considered more directly in the audit—referred to as *auditing through the computer*. Yet, auditing through the computer remains a challenge for auditors. Whereas a client’s employees generally need familiarity with the system their company uses, a difficult task for

many in and of itself, auditors face differing systems on each of their audits.

Today, auditors are still able to audit computer inputs and outputs in various circumstances. Yet, the combination of more sophisticated computer processing and the accounting profession’s requirement that a “risk based” approach be adopted on audits has made the historical concept of ignoring computer processing unacceptable in most audits. Thus, for example, when customer orders are constantly being accepted electronically, there may be no hard copy source document on which to address the completeness of which processing of inputs has occurred. As we’ve discussed in this and Chapter 7, auditors must assess risks of material misstatement and in various circumstances consider control design and implementation. In essence, while the term “auditing around the computer” is still sometimes used to refer to auditing inputs and outputs, it is a more limited concept than the original one due to changes in IT and audit requirements, particularly requirements to perform a risk assessment and situations in which substantive procedures alone do not provide adequate assurance.

such as minutes of meetings of users and IT staff, and inspecting the documentation of the tests performed on the systems before they were implemented. The auditors may have discussions with users to determine that they understand the systems and to obtain their assessments of the operation of the system.

To test controls over program changes, the auditors may review the documentation of any changes made and the related authorization. Manuals being used by users and operators may be inspected to determine that they are the most recent versions.

Controls over access to programs and data may be tested through inquiry of client personnel and observation of the segregation of duties and physical controls over equipment. The auditors can also compare access privileges to job titles. Documentary evidence related to authorization for access to programs and data may be reviewed, and the auditors may observe the use of authentication techniques (e.g., passwords). The IT-generated log of access violations may be inspected for evidence of review and follow-up by control group personnel. Finally, to test for unauthorized users, the auditors may use automated tools and techniques to compare password files (or other authentication files) to listings of current employees.

Operations controls may be tested through inquiry of computer operators about adherence to policies, observation of segregation of duties, and examination of evidence of control group follow-up on exceptions and other issues. The auditors also may review reports summarizing appropriate corrective actions taken on operations problems by computer operators, vendors, programmers, the database administrator, and users.

Procedures to Test Application Controls

Tests of application controls vary significantly, depending upon the nature of the system and application. For example, in a batch system, input controls may be tested by reviewing and verifying reconciliations of batch control totals and comparing control totals to IT output.

In an online real-time system, control totals often are not used, and the auditors will design tests to ensure that only authorized data are accepted as input and input validation checks are applied to ensure the accuracy of the data. In addition to these tests of specific application controls, as indicated in the preceding section, the auditors will often need to consider general controls such as overall unauthorized program and data change controls. Thus, to address accuracy of the data for a particular application, auditors will often also consider general controls as well as application controls.

The auditors will test the manual follow-up activities by inspecting the exception reports generated by the system and reviewing the way in which exceptions were handled. Analysis of exception reports may be especially effective when commercial off-the-shelf software is being used, but only if the auditors are confident that the software is reliable and has not been modified inappropriately. For example, the software may (or may not) be extremely well established and have a reputation for reliability. Also, the degree to which the software allows users to modify the source code or allows flexibility of configuration may affect information accuracy and completeness and the resulting risks of material misstatement.

Certain tests of controls may be performed with data analytics. As an example, the auditors may obtain electronic records of sales transactions and the customer master file. By relating these two sets of records, the auditors can determine that all sales transactions were authorized by an appropriate sales employee and approved by an authorized employee in the credit department. The auditors may also determine that customers were not allowed to exceed their credit limits. Using data analytics, the auditors can perform these tests on 100 percent of the records as opposed to manually testing a sample of the items.

To perform data analytics tasks and tests of application controls built into the software, the auditors use automated tools and techniques. These tools and techniques include *test data*, *integrated test facilities*, *controlled programs*, *program analysis techniques*, *tagging and tracing*, and *generalized audit software programs*. Automated tools and techniques are used by both external and internal auditors to monitor and test the performance of IT systems.

Test Data

In the audit of a manual accounting system, the auditors trace sample transactions through the *records* from their inception to their final disposition. In the audit of an IT-based system, a comparable approach is the use of **test data**. Test data may confirm the operations of a system by determining that a set of test data produces an expected result. To test programmed controls, the test data also should include significant exceptions that would affect the auditors' assessment of control risk (or the risk of material misstatement). Among these would be transactions with missing data, erroneous transactions, illogical transactions, out-of-balance batches, and out-of-sequence records. The auditors will carefully appraise the programmed controls that relate to financial statement assertions for which they wish to conclude that controls operate effectively. Dummy transactions and records used in test data can be specially coded to avoid contamination of the client's genuine records and files. If the client's IT-based system includes an integrated test facility, the auditors may use this facility to prevent their test data from contaminating the client's files.

Integrated Test Facility

One method used more often by internal auditors to test and monitor controls in computer applications is an **integrated test facility**. An integrated test facility is a subsystem of dummy records and files built into the regular IT-based system. These dummy files permit test data to be processed simultaneously with regular (live) input without adversely affecting the live data files or output. The test data, which include transactions and exceptions pertaining to controls to be tested, affect only the dummy files and dummy output. For this reason, an integrated test facility is often called the *mini-company approach* to testing the system. Integrated test facilities may be built into both batch and online real-time IT systems.

The auditors monitor the processing of test data, studying the effects upon the dummy files, exception reports, and other output produced. An integrated test facility for payroll applications, for example, could be set up by including a fictitious department and records for fictitious employees in the payroll master file. Input data for the dummy department would be included with input data from actual departments. The auditors would monitor all output relating to the dummy department, including payroll records, exception reports, and payroll checks. In this situation, strict control would be necessary to prevent misuse of the dummy payroll checks.

Controlled Programs

As an alternative or supplement to the test data approach, the auditors may monitor the processing of current data by using a duplicate program that is held under their control. They then compare their output to that developed by the client's copy of the program. They also may reprocess historical data with their controlled program for comparison with the original output. Reprocessing historical data may alert the auditors to undocumented changes in the client's programs.

Controlled programs are advantageous because the auditor may test the client's program with both genuine (live) and test data. Through controlled programs, auditors may test programmed controls without risk of contaminating the client's files. Also, the testing may be conducted at an independent IT facility without using the client's computer or information systems personnel.

Program Analysis Techniques

Program analysis techniques have been developed that can generate computer-made flowcharts of other programs. A trained auditor can examine the flowcharts to test the logic of application programs and to ensure that the client's program documentation describes the program that is actually being used.

Tagging and Tracing Transactions

This technique involves *tagging* transactions with an indicator when they are entered into the system. The computer provides the auditors with a printout of the details of the steps in processing tagged transactions. This printout is examined for evidence of unauthorized program steps. **Tagging and tracing** is possible only when the appropriate logic has been built into the IT-based system.

Generalized Audit Software

Most CPA firms use **generalized audit software** (computer programs) that can be used to test the reliability of the client's programs as well as to perform many specific auditing functions. This audit software is suited for use on a wide variety of IT-based systems as well as to use data analytical approaches, as discussed in Chapter 5. ACL and IDEA are two widely used commercial products.

A significant value of generalized audit software lies in the fact that the auditors are able to conduct independent processing of live data. Often, the verification of the client's output would be too large a task to be undertaken manually, but it can be done efficiently using generalized audit software. Even when manual verification is possible, the use of generalized audit software allows the auditors to expand greatly the size of the sample of transactions to be tested. An extensive examination of the client's files may become a feasible and economic undertaking. It is not necessary, however, to duplicate all the client's IT processing. Testing should be performed only to the extent necessary to support the auditors' assessment of control risk.

Procedures to Test User Controls

Tests of user controls will vary significantly with the nature of the control. However, the primary objective is to obtain assurance that users are, at a minimum, testing IT output for reasonableness. Therefore, typical tests involve inquiries of users about test procedures performed and inspection of any documentation that exists, such as exception reports.

Testing Monitoring Controls

Because IT systems make it possible to continuously monitor processes and transactions, monitoring controls can be very effective at discovering potential statements. As a result, auditors are increasingly considering and testing such controls. Evidence of the performance of monitoring controls is found in the computer-generated reports that identify unusual transactions or items. The auditors should also examine evidence of follow-up by client personnel on the transactions and items identified.

Evidence When Services Are Outsourced

When an organization outsources portions of its IT system to a service provider (e.g., a cloud service provider), the auditors generally obtain a report from the provider's auditors (service auditors). As discussed in Chapter 7, there are the following two types of reports that service auditors may provide:

- *Type 1 report*—A report on a management's description of a service organization's system and the suitability of the design of controls.
- *Type 2 report*—A report on a management's description of a service organization's system and the suitability of the design *and operating effectiveness of controls* (throughout the period covered by the service auditor's report).

While a Type 1 report may be sufficient if the organization is using the provider only to access application programs, the auditors will generally require evidence about operating effectiveness when the provider's services are more extensive (e.g., storing the organization's accounting data). If a Type 2 report is not available, the auditors may find it necessary to perform their own tests of the provider's controls.

Designing Substantive Procedures That Use Automated Tools and Techniques

LO 8-7

Describe the nature of automated tools and techniques and the ways that they are used by the auditors.

To use automated tools and techniques to test the records, the auditors must first find a way to access the records. In many situations, this is not particularly difficult. As an example, the auditors may obtain a copy of the client's records that can be analyzed and processed on the auditors' computer. In other situations, the auditors may decide to "download" the client's data to the auditors' computer. Finally, the auditors' generalized audit software may be run on the client's IT-based system to directly access the client's computer records.

Once the auditors have accessed the client's records, substantive procedures applied to the records can be performed using automated tools and techniques. Audit software may be used to rearrange the data in a format more useful to the auditors, compare the data to data from other sources, make computations, and select random samples. Applications of this nature include

1. *Examining the client's records for overall quality, completeness, and valid conditions.* In auditing a manual system, the auditors become aware of the general quality, accuracy, and validity of the client's records through visual observation. Because the auditors do not have the same physical contact with computer-based records, the audit software may be used to scan the client's files for various improprieties. For example, the accounts receivable file may be scanned for account balances in excess of credit limits, and the depreciation expense may be recomputed for each item in the plant assets file. The great speed of the computer often makes it possible to perform such calculations for each item in the population, rather than having to rely upon a sample-based test.
2. *Rearranging data and performing analyses.* The audit software may be used to rearrange the data in the client's files into a format more useful to the auditors.

For example, the accounts receivable file may be reorganized into the format of an aging of accounts receivable. Data from the client's files may be printed out in the format of the auditors' working papers. In addition, the audit software can make analytical computations, such as computing turnover ratios to identify slow-moving inventory.

3. *Selecting and evaluating audit samples.* Audit samples may be selected from the client's files on a statistical or nonstatistical basis, and evaluated statistically. Examples include selection of the inventory items to be test counted and the accounts receivable to be confirmed. An additional time savings may result if the audit software is used to print out the actual confirmation requests.
4. *Comparing data in separate files.* When similar data are contained in two or more files, the audit software can compare the files and identify any discrepancies. For example, the changes in accounts receivable over a period of time may be compared to the details of the cash receipts and credit sales transactions files. Also, actual operating results may be compared to budgets or forecasts.
5. *Performing audit data analytics.* Audit data analytics may be used to perform sophisticated analytical procedures to gain insights from examining relationships between various internal and external, operational and financial data. These insights may help the auditors to identify likely misstatements. In performing audit data analytics procedures, it is important for the auditors to test the reliability of all data being used. This can be done by testing the controls over the development of the data or testing its accuracy and completeness directly.
6. *Comparing the results of audit procedures with the client's records.* Data obtained by the auditors may be used (or converted to machine-readable form) and compared to the data in computer-based files. For example, as is discussed in further detail in Chapter 11, confirmation requests may be sent, and replies received, electronically. Also, the results of the auditors' inventory test counts can be compared to the perpetual inventory file.

Using Audit Software: An Illustration

To illustrate some of the possible uses of generalized audit software, let us consider a specific example. Assume that an auditor is planning to observe a client's physical count of inventories at a specific date. All inventory is stored either in the client's distribution center or at a public warehouse. The client maintains computer-based perpetual inventory records, which are updated daily. This inventory file contains the following information:

Part number.	Location.
Cost per unit.	Date of last sale.
Description of item.	Quantity on hand.
Date of last purchase.	Quantity sold during the year.

The client has provided the auditor with a computerized copy of the inventory file as of the date of the physical count.

The left-hand column in Figure 8.5 indicates typical inventory audit procedures the CPA might perform. The right-hand column indicates how generalized audit software might be helpful in performing these procedures.

Auditors do not need extensive technical IT knowledge in order to make use of generalized audit software. In fact, many CPA firms have found that they can train auditors to effectively use generalized audit software within a few days. Because of the simplified procedures that have been developed, auditors, after limited training, can use generalized audit software independently to test client records.

FIGURE 8.5 Illustration of the Uses of Generalized Audit Software

Basic Inventory Audit Procedure	How Generalized Audit Software Might Be Used
1. Observe the physical count, making appropriate test counts.	Determine which items are to be test counted by selecting from the inventory file a sample of items that provides the desired dollar coverage.
2. Test the mathematical accuracy of the inventory extensions and footings.	For each item in the inventory file, multiply the quantity on hand by the cost per unit and add the extended amounts.
3. Compare the auditors' test counts to the inventory records.	Organize the auditors' test counts and compare them to inventory records.
4. Compare the client's physical count data to the inventory records.	Compare the quantity of each item counted to the quantity on hand in the inventory file.
5. Perform a lower-of-cost-or-net-realizable-value test by obtaining a list of current costs per item from vendors.	Compare the net realizable value to the cost per unit in the inventory file; print out the extended value for each item, using the lower of the two unit costs, and add extended amounts.
6. Test purchase and sales cutoff.	List a sample of items on the inventory file for which the date of last purchase or last sale is on, or immediately before, the date of the physical count.
7. Confirm the existence of items located in public warehouses.	List items located in public warehouses and print confirmations.
8. Analyze inventory for evidence of obsolescence or slow-moving items.	List items from the inventory file for which the turnover ratio (quantity sold divided by quantity on hand) is low or for which the date of last sale indicates a lack of recent transactions.

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Chapter Summary

This chapter describes the auditors' consideration of internal control in an IT environment. To summarize:

1. Auditors encounter IT-based record keeping in virtually every audit engagement. Even the smallest of audit clients can be expected to use a computer to process its accounting records.
2. The use of an IT system by a client does not change the need to establish effective internal control; however, it does change the nature of the controls. More advanced IT features, such as online capabilities, database storage, IT networks, and end user computing, present special control risks. Therefore, specialized controls are needed, including passwords, validity tests, and computer logs.
3. The use of information technology may significantly affect the control system of the organization. From an organizational standpoint, it is essential to segregate the function of programming from the function of controlling input to the computer programs, and the function of the computer operator from the function of those having detailed knowledge or custody of the computer programs.
4. IT controls are often classified as general controls, application controls, and user controls. General controls apply to all (or many) IT applications, and application controls and user controls relate only to a specific application. The auditors often consider general controls first because application and user controls cannot be assumed to be effective if the general controls are weak.
5. To test application controls, the auditors will often use automated tools and techniques, such as test data, controlled programs, program analysis techniques, and tagging and tracing transactions.
6. While generalized audit software also may be used to test application controls, it is more often used by the auditors to perform substantive procedures applied to computerized records. Generalized audit software may be used to perform such functions as testing the clerical accuracy of records, making comparisons of related data, and selecting random samples.

Key Terms Introduced or Emphasized in Chapter 8

Application controls (365) In an IT environment, controls relating to a specific IT task, such as preparation of payroll. Also referred to as information-processing controls and transaction controls.

Application software (357) Software designed to perform a specific task, for example, preparation of the general ledger.

Automated tools and techniques (371) Automated tools and techniques are existing and emerging tools and technologies used by management and auditors to efficiently and effectively perform repetitive tasks. These include such tools and technologies as artificial intelligence, robotic process automation, machine learning, and specialized software.

Batch processing (358) A system in which like transactions are processed periodically as a group.

Big data (359) Extremely large data sets that may be analyzed to reveal patterns, trends, and associations. As an example, consider the millions (or billions) of records relating to potential customers arising from various social media sources.

Bitcoin (362) A type of digital currency that uses encryption to regulate the generation of units of currency and verify the transfer of funds, operating independently of any financial institutions. Bitcoins, which are electronic and not physical, can be traded for goods or services with vendors who accept them as payment.

Blockchain (362) A decentralized database that maintains a continuously growing list of ordered records called blocks. A blockchain allows various parties to share a digital decentralized ledger across a network of computers without a centralized authority (e.g., a bank). Proponents argue that a blockchain allows the recording of transactions across computers in such a way that the transactions cannot be altered retroactively. This allows those involved to have confidence in the accuracy of the transactions.

Centralized processing systems (371) Computer systems in which processing is performed by one computer or by a cluster of coupled computers in a single location. Data are often input and reports printed using workstations. When the workstations themselves perform significant processing, the system becomes a client/server environment.

Certificate Authority (368) A Certificate Authority is a trusted organization that issues electronic certificates that verify the identity of organizations on the Internet.

Change request log (367) A log that consists of suggestions for changes in programs. These changes often have been initiated by users who have noted problems or possible enhancements for a program.

Client/server architecture (IT architecture) (356) A network system in which multiple computers (clients) share the memory and other capabilities of a larger computer (the server), or that of printers, databases, and so on.

Cloud computing (356, 360) A model for enabling on-demand user network access to a shared pool of computing resources (e.g., servers, storage, applications, and services), often through a web browser, with minimal effort on the part of the user. For example, an independent service provider may maintain databases for a client that can be accessed in a number of locations by client personnel.

Controlled programs (379) Duplicate client application programs that are maintained under the auditors' control in order to test the programmed control activities.

Controls (358) Policies and procedures that an entity establishes to achieve the control objectives of management or those charged with governance. Policies are statements of what should, or should not, be done within the organization to effect control; procedures are actions to implement policies.

Data mining (359) A process of analyzing data from different perspectives and summarizing it into useful information. It allows users to analyze data from various dimensions, to categorize it, and to summarize the relationships identified.

Data warehouse (359) A subject-oriented, integrated collection of data used to support management decision-making processes.

Database system (357) A structured set of data held in a computer, especially one that is accessible in various ways. Such a system ordinarily minimizes data redundancy, enforces data integrity by storing data separately from (outside) programs, and contains data for two or more IT applications.

Decentralized processing systems (370) Computer systems in different locations. Although data may be transmitted between the computers periodically, such a system involves only limited communications among systems. Contrast with distributed processing and centralized processing.

Decision support systems (359) IT information systems that combine models and data in an attempt to solve nonstructured problems with extensive user involvement.

Electronic commerce (361) Involves the electronic processing and transmission of data between customer and client. A variety of activities may be included, such as electronic trading of goods and services, online delivery of digital products, and electronic funds transfer.

Electronic data interchange (EDI) (361) A system in which data are exchanged electronically between the computers of different companies. In an EDI system, source documents are replaced with electronic transactions created in a standard format.

Encryption (367) The process of encoding a message to prevent unauthorized access to the information.

End user computing (361) An environment in which a user department is responsible for developing or purchasing, and running, an IT system (application) with minimal or no support from the central information systems department.

Enterprise resource planning (ERP) systems (358) An ERP system is an integrated system that allows an organization to collect, store, manage, and interpret data from most or all of its various activities.

Expert system (359) A computerized information system that guides decision processes within a well-defined area and allows the making of decisions comparable to those of an expert.

Firewall (361, 368) A network security system that monitors and controls the incoming and outgoing network access and data based on predetermined security criteria.

General controls (365) In an IT environment, controls over the entity's IT processes that support the continued proper operation of the IT environment, including the continued effective functioning of information-processing controls and the integrity of information in the entity's information system. Referred to as general information technology (IT) controls and IT general controls.

Generalized audit software (379) Computer programs used by auditors to locate and process data contained in a client's IT-based records. The programs perform such functions as rearranging the data in a format more useful to the auditors, comparing records, selecting samples, and making computations. This software is compatible with a wide variety of different IT systems.

Hard copy (369) IT output in printed form, such as printed listings, reports, and summaries.

Information-processing controls (365) Controls relating to the processing of information in IT applications or manual information processes in the entity's information system that directly address risks to the integrity of information. Also referred to as transaction controls.

Integrated test facility (378) A set of dummy records and files included in an IT system enabling test data to be processed simultaneously with live input.

Internet (359) An international network of independently owned computers that operates as a giant computing network. Data on the Internet are stored on "Web servers," which are computers scattered throughout the world.

Intranet (360) Internal networks to a company that allow employees to use Internet capabilities, such as browsers, search engines, and e-mail.

IT application controls (369) Controls relating to a specific IT task, such as preparation of payroll. They include both programmed controls that are written into the computer software and manual follow-up activities performed on the exception reports that are generated by the system. Those emphasized on audits are also referred to as transaction controls or information-processing controls.

IT general controls (366) Controls over the entity's IT processes that support the continued proper operation of the IT environment, including the continued effective functioning of information-processing controls and the integrity of information in the entity's information system.

Local area network (LAN) (359) A communications network that interconnects computers within a limited area, typically a building or a small cluster of buildings.

Malware (369) Software that is designed to disable or damage computer systems or data.

Master file (369) A file of relatively permanent data or information that is updated periodically; for example, an employee master file.

Off-the-shelf software (356) Commercially available software created for a variety of users in the same industry or with the same application.

Online analytical processing (OLAP) (359) An information system that allows the user to query the system, conduct an analysis, etc., while the user is at a computer. The database for an OLAP system is often generated from the transactions-based database used for online transaction processing.

Online processing (358) A system that allows immediate update or access to data, or instantaneous analysis of data.

Online transaction processing (OLTP) (358) A processing method in which the IT system processes data immediately after it is captured and provides updated information to the user on a timely basis. OLTP examples include airline reservation systems and banking systems.

Operating system (357, 369) Software that coordinates and controls hardware components. For example, authorization procedures may be programmed into the operating system to restrict access to files and programs to authorized personnel only.

Operations manual (369) A manual that contains the instructions for processing a program. The manual should include sufficient information to allow operators to effectively operate programs but should not include detailed program documentation.

Patch (364) A new section of coding added in a rough or expedient way to modify a program.

Program analysis techniques (379) Techniques for testing programmed control activities that involve the examination of computer-generated flowcharts of application programs.

RAM (360) RAM (random access memory) is a form of computer data storage for frequently used instructions and data to increase the general speed of a system.

Ransomware (369) Malware that infects a system or device, preventing access to data unless a ransom is paid.

Risks arising from the use of IT (372) The susceptibility of information-processing controls to ineffective design or operation, or risks to the integrity of information in the entity's information system, due to ineffective design or operation of controls in the entity's IT processes.

Software virus (371) A program that can attach itself to a legitimate program and modify other programs and systems. A virus may cause the loss of data or programs on a system.

Tagging and tracing (379) A technique for testing programmed control activities in which selected transactions are tagged when they are entered for processing. A computer program provides a printout of the steps in processing the tagged transactions that may be reviewed by the auditors.

Test data (363, 378) A set of dummy records and transactions developed to test the adequacy of a computer program or system.

Tightly coupled (360) A system in which hardware and software are not only linked together, but are also very dependent upon each other. In such a system where multiple systems share a workload, the entire system might need to be taken off-line to fix a major hardware or software problem, not just the single system with the issue.

Transaction controls (365) Controls that directly support actions to mitigate information-processing risks in an entity's business processes. Also referred to as information-processing controls.

Transaction file (357) A transaction file is a collection of transaction records; for example, a sales file.

User controls (365) Controls performed by users of IT information to test its accuracy and completeness.

User operated computer (371) A general-purpose computer designed to be used by one person at a time. This computer is often connected to a network of computers, and the user utilizes it for a variety of business-related purposes.

Virtualized client/server infrastructure (360) A software-based IT infrastructure being hosted on another physical infrastructure. This type of infrastructure is used for cloud computing.

Wide area network (WAN) (359) A communications network that interconnects computers within a large geographical area.

Workstation (370) A general-purpose computer designed to be used by one person at a time. A workstation is often connected to a network of computers. Increases in the power of personal computers have blurred the distinction between personal computers and workstations. While workstations are generally more powerful, in this text we will not distinguish between the two.

Review Questions

- 8-1. List and describe the major components of an information system.
- 8-2. Discuss the nature of end user computing.
- 8-3. What is meant by a local area network?
- 8-4. Distinguish between user controls and manual application controls.
- 8-5. What is cloud computing?
- 8-6. Distinguish general controls from application controls and give examples of the types of controls included in each of these broad categories.

- 8-7. An information systems department usually performs numerous IT processing functions that would be separated in a manual system. Does this imply that separation of duties is not a practical means of achieving internal control in a computerized system? Explain.
- 8-8. Explain briefly what is meant by an “online real-time system.”
- 8-9. Explain the meaning of the term *documentation* as it pertains to computers and an information systems department. How might a client’s documentation be used by the auditors?
- 8-10. The number of personnel in an information systems department may limit the extent to which segregation of duties is feasible. What is the minimum amount of segregation of duties that will permit satisfactory internal control?
- 8-11. What is blockchain technology and how could it eventually change financial reporting and auditing?
- 8-12. Define and give the purpose of each of the following controls:
- Record counts
 - Limit test
 - Validity test
 - Hash totals
 - Missing data test
- 8-13. What is meant by “authentication of the user,” and how may authentication be achieved?
- 8-14. What is the difference between an Internet-based and an intranet-based information system?
- 8-15. Describe briefly the controls that should be established over the operation of a workstation to prevent use by unauthorized personnel.
- 8-16. What are the advantages of a *virtualized client/server infrastructure*?
- 8-17. Explain briefly what is meant by *malware* and *ransomware*.
- 8-18. Explain briefly what is meant by *electronic data interchange (EDI)*. How does EDI affect a company’s audit trail?
- 8-19. Is it probable that the use of IT will eventually eliminate the audit trail, making it impossible to trace individual transactions from their origin to the summary totals in the financial statements? Explain.
- 8-20. Do auditors usually begin their consideration of internal control over IT activities with a review of general or application controls? Explain.
- 8-21. Describe the audit technique known as *tagging and tracing*. What is the purpose of the technique?

Questions Requiring Analysis

LO 8-3

- 8-22. A primary requirement of effective internal control is a satisfactory plan of organization. Explain the characteristics of a satisfactory plan of organization for an information systems department, including the relationship between the department and the rest of the organization.

LO 8-6, 7

- 8-23. Assume the auditors of a company with an IT system have determined that general controls are effective. They are currently auditing the application controls over sales and wish to test the following controls:

- Authorization of sales transactions by sales personnel.
- Authorization and enforcement of credit limits by credit personnel.

Describe how the auditors could test these controls in an efficient manner using data analytics.

LO 8-2

- 8-24. Auditors encounter user operated computers on almost every audit engagement.

- How do user operated computers differ from large computer systems?
- When are the auditors concerned with internal control over the use of user operated computers?

LO 8-6

- 8-25. The use of test data is one method of performing tests of processing controls in an IT-based system. Identify and discuss several other methods by which auditors may test internal processing controls over IT activity.

LO 8-7

- 8-26. Discuss how generalized audit software can be used to aid the auditors in examining accounts receivable in an IT-based system.

- LO 8-6** 8–27. An integrated test facility (ITF) is a method used primarily by internal auditors for testing IT-based system controls. Discuss the advantages and disadvantages of implementing an ITF. (CIA, adapted)
- LO 8-4** 8–28. Many companies have part or all of their IT processing done by cloud service providers.
- What controls should the company maintain to ensure the accuracy of processing done by a cloud service provider?
 - How do auditors assess internal control over applications processed for an audit client by a cloud service provider?
 - What is a service auditor's report on the processing of transactions by a service organization?
 - Describe the two types of reports provided by service auditors.

Objective Questions

Select questions are available with Connect



- LO 8-2** 8–29. **Multiple Choice Questions**
Select the best answer for each of the following questions. Explain the reasons for your selection.
- LO 8-1, 2** a. LAN is the abbreviation for:
- Large area network.
 - Local area network.
 - Longitudinal analog network.
 - Low analytical nets.
- LO 8-4** b. End user computing is most likely to occur on which of the following types of computers?
- Mainframe.
 - Decision support systems.
 - Personal computers.
 - Personal reference assistants.
- LO 8-4** c. When erroneous data are detected by computer program controls, data may be excluded from processing and printed on an exception report. The exception report should probably be reviewed and followed up by the:
- Data control group.
 - System analyst.
 - Supervisor of IT operations.
 - Computer programmer.
- LO 8-4** d. An accounts payable program posted a payable to a vendor not included in the online vendor master file. A control that would prevent this error is a:
- Validity check.
 - Range check.
 - Limit test.
 - Control total.
- LO 8-2** e. When an online real-time (OLRT) IT processing system is in use, internal control can be strengthened by:
- Providing for the separation of duties between data input and error handling operations.
 - Reconciling hash totals to computer runs.
 - Use of authentication procedures before a user can obtain access to the computer files.
 - Preparing batch totals to provide assurance that file updates are made for the entire input.
- LO 8-2, 4** f. The auditors would most likely be concerned with which of the following controls in a distributed data processing system?
- Hardware controls.
 - Systems documentation controls.
 - Access controls.
 - Disaster recovery controls.

LO 8-7

- g. The auditors would be least likely to use audit software to:
- (1) Access client data files.
 - (2) Prepare spreadsheets.
 - (3) Assess computer control risk.
 - (4) Test application programs.

LO 8-1

- h. Which of the following is not a major component of an information system?
- (1) People.
 - (2) Data.
 - (3) Review.
 - (4) Software.

LO 8-5

- i. Which of the following is least likely to be considered by the auditors considering engagement of an information technology specialist on an audit?
- (1) Complexity of the client's systems and IT controls.
 - (2) Number of financial institutions at which the client has accounts.
 - (3) Client's use of emerging technologies.
 - (4) Extent of the client's participation in electronic commerce.

LO 8-7

- j. Which of the following is an advantage of generalized audit software packages?
- (1) They are all written in one identical computer language.
 - (2) They can be used for audits of clients that use differing computing equipment and file formats.
 - (3) They have reduced the need for the auditor to study input controls for computer-related procedures.
 - (4) Their use can be substituted for a relatively large part of the required tests of controls.

LO 8-4

- k. The increased presence of user operated computers in the workplace has resulted in an increasing number of persons having access to the system. A control that is often used to prevent unauthorized access to sensitive programs is:
- (1) Backup of data in the cloud.
 - (2) Authentication procedures.
 - (3) Input validation checks.
 - (4) Record counts of the number of input transactions in a batch being processed.

LO 8-6

- l. An auditor will use the computer test data method in order to gain assurances with respect to the:
- (1) Security of data in a system.
 - (2) IT system capacity.
 - (3) Controls contained within a program.
 - (4) Degree of data entry accuracy for batch input data.

LO 8-2

- 8–30. Auditors should be familiar with the terminology employed in IT processing. The following statements contain some of the terminology so employed. Indicate whether each statement is true or false.
- a. A recent improvement in computer hardware is the ability to automatically produce error listings. Previously, this was possible only when provisions for such a report were included in the program.
 - b. The control of input and output to and from the information systems department should be performed by an independent *data control group*.
 - c. An internal-audit computer program that continuously monitors IT processing is a feasible approach for improving internal control in *OLRT systems*.
 - d. In *cloud-based systems*, programs are typically housed by service providers.
 - e. A limit test in a computer program is comparable to a decision that an individual makes in a manual system to judge a transaction's reasonableness.

- f. An organization that has an intranet housed on a *local area network (LAN)* does not have to be concerned with unauthorized access.
- g. *Online transaction processing systems* are closely related to *expert systems*.
- h. In a *three-tier client/server* environment, presentation, processing, and data storage are separated.
- i. The *systems development life cycle* is a system for securing programs and data.

- LO 8-6, 7** 8–31. For each of the following descriptions, select the computer audit procedure most closely related. Computer audit procedures may be used once, more than once, or not at all.

Definition	Computer Audit Procedures
a. Auditing by manually testing the input and output of a computer system.	1. Auditing “around” the computer
b. Dummy transactions developed by the auditor and processed by the client’s computer programs, generally for a batch processing system.	2. Tagging and tracing
c. Fictitious and real transactions are processed together without the client’s operating personnel knowing the testing process.	3. Integrated test facility
d. May include a simulated division or subsidiary in the accounting system with the purpose of running fictitious transactions through it.	4. Controlled program
e. Involves testing of a version of the organization’s software without concerns about contaminating the organization’s records.	5. Limit test
	6. Test data

- LO 8-1, 2** 8–32. For each definition (or partial definition) in the first column below, identify the most closely related term. Each term may be used once or not at all.

Definition (or Partial Definition)	Term
a. A subject-oriented, integrated collection of data used to support management decision-making processes.	1. Batch processing
b. A system in which like transactions are processed periodically as a group.	2. Data warehouse
c. An environment in which a user department is responsible for developing, or purchasing and running, an IT system (application) with minimal or no support from the central information systems department.	3. Database system
d. A system that eliminates data redundancy and enforces data integrity by storing data separately from (outside) programs and that contains data for two or more IT applications.	4. Decentralized processing system
e. Computer systems in different locations.	5. End user computing
	6. Extranet
	7. Operating system
	8. System software

Problems

- 8–33. The Trust Life Insurance Company has a database system that stores policy and payment information. The company is now planning to provide its branch offices with terminals that have online access to the central IT facility.
- a. Define a *database*.
 - b. Give one fundamental advantage of a database.
 - c. Describe three security measures to safeguard the database system from improper access through the terminals.
- (CIA, adapted)

- 8–34. CPAs may audit around or through computers in the audit of the financial statements of clients who use IT to process accounting data.
- Describe the auditing approach referred to as “auditing around the computer.”
 - Under what conditions do CPAs decide to audit through the computer instead of around the computer?
 - In auditing through the computer, CPAs may use test data.
 - What are test data?
 - Why do CPAs use test data?
 - How can the CPAs be satisfied that the computer programs presented to them for testing are actually those used by the client for processing accounting data?
(AICPA, adapted)

- LO 8-4, 5** 8–35. As you are planning the annual audit of Willis Corporation, you note that the company has a number of user operated computers in use in various locations. One of the machines has been installed in the stores department, which has the responsibility for disbursing stock items and for maintaining stores records. In your audit, you find that one employee receives the requisitions for stores, disburses the stock, maintains the records, operates the computer, and authorizes adjustments to the total amounts of stock recorded by the computer.

When you discuss the applicable controls with the department manager, you are told that the user operated computer is assigned exclusively to that department. Therefore, the manager contends that it does not require the same types of controls applicable to large IT systems.

- Comment on the manager’s contention.
- Discuss five types of control that would apply to this microcomputer application.
(CIA, adapted)

- LO 8-4** 8–36. You are auditing for the first time the financial statements of Midwest Savings and Loan Association for the year ending December 31, 20X3. The CPA firm that audited the association’s financial statements for the prior year issued an unqualified audit report.

The association uses an online real-time IT-based system. Each teller in the association’s main office and seven branch offices has an online terminal. Customers’ mortgage payments and savings account deposits and withdrawals are recorded in the accounts by the computer from data input by the teller at the time of the transaction. The teller keys the proper account by account number and enters the information in the terminal to record the transaction. The IT facility is housed at the main office.

You would expect the association to have certain controls in effect because an online real-time IT-based system is used. List the controls that should be in effect solely because this type of system is used, classifying them as:

- Those controls pertaining to input of information.
- All other types of IT controls.

- LO 8-4, 5** 8–37. Lee Wong, CPA, is auditing the financial statements of the Alexandria Corporation, which has a batch-processing IT-based system for shipping and invoicing that it purchased from a software vendor. The following comments have been extracted from Wong’s notes on IT operations and the processing and control of shipping notices and customer invoices.

Each type of computer run is assigned to a specific employee who is responsible for making program changes, running the program, and answering questions. This procedure has the advantage of eliminating the need for records of IT operations because each employee is responsible for their own computer runs. At least one IT department employee remains in the computer room during office hours, and only IT department employees have keys to the computer room.

The corporation considered the desirability of program controls but decided to retain the manual controls in place prior to the conversion to the software vendor’s system.

Company products are shipped directly from public warehouses, which forwards shipping notices to general accounting. A billing clerk then enters the price of the item and accounts for

the numerical sequence of shipping notices from each warehouse. Mathematical extensions are made by the computer. Output consists of invoices (in six copies) and a daily sales register. The daily sales register shows the aggregate totals of units shipped and unit prices, which the computer operator compares to the control tapes.

All copies of the invoice are returned to the billing clerk. The clerk mails three copies to the customer, forwards one copy to the warehouse, maintains one copy in a numerical file, and retains one copy in an open invoice file that serves as a detailed accounts receivable record.

Describe weaknesses in internal control over information and data flows and the procedures for processing shipping notices and customer invoices, and recommend improvements in these controls and processing procedures. Organize your answer sheets as follows:

Weakness	Recommended Improvement

(AICPA, adapted)

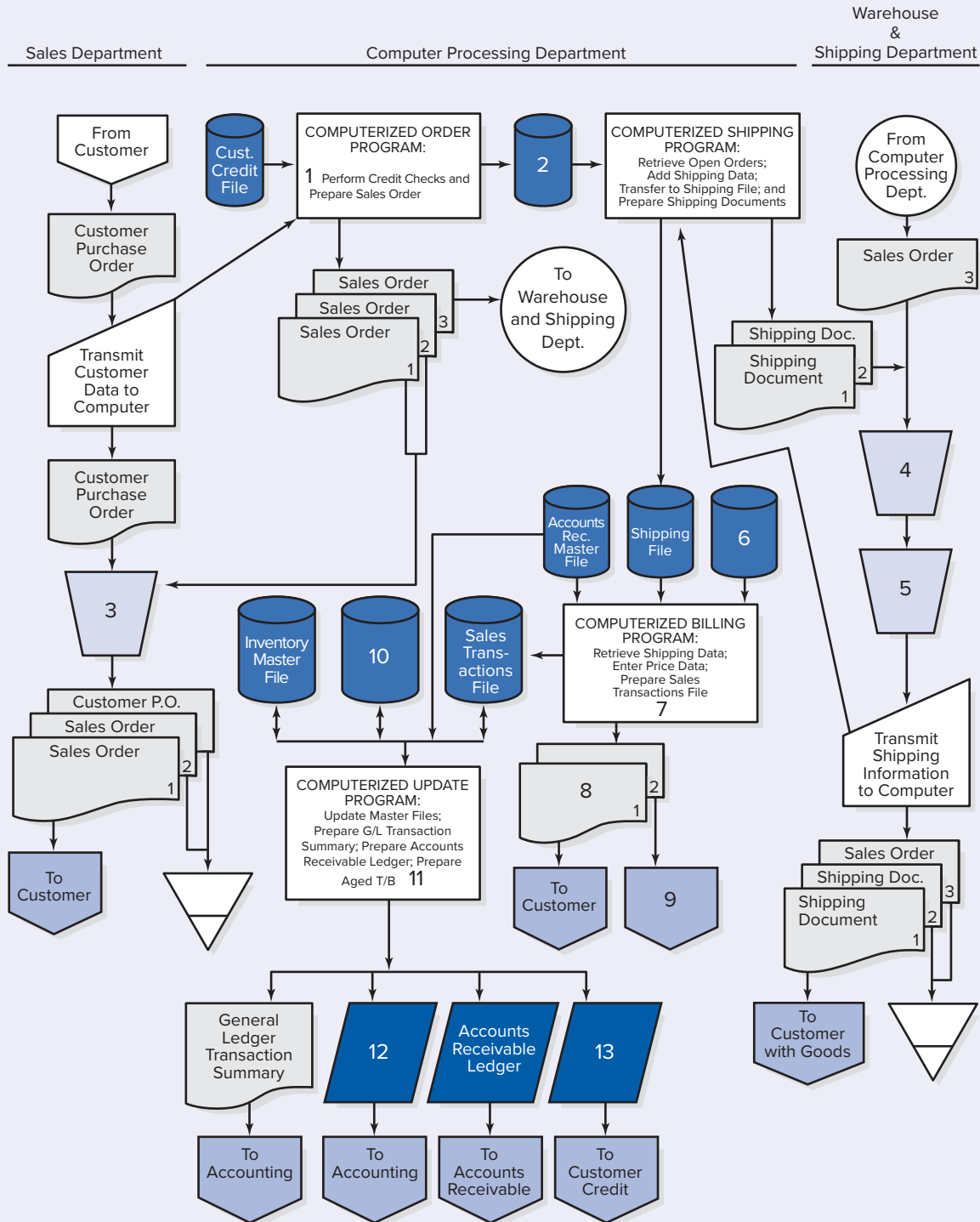
In-Class Team Case

- 8–38. The accompanying flowchart summarizes Trendel Corporation's processing of sales. Some of the flowchart symbols are labeled to indicate controls and records. For each symbol numbered 1 through 13, select one response from either the list of operations and controls (A through O) or the list of documents, journals, ledgers, and files (P through Z).

Operations and Controls	Documents, Journals, Ledgers, and Files
A. Enter shipping data	P. Shipping document
B. Verify agreement of sales order and shipping document	Q. General ledger master file
C. Write-off of accounts receivable	R. General journal
D. To warehouse and shipping department	S. Master price file
E. Authorize accounts receivable write-off	T. Sales journal
F. Prepare aged trial balance	U. Sales invoice
G. To sales department	V. Cash receipts journal
H. Release goods for shipment	W. Uncollectible accounts file
J. To accounts receivable department	X. Shipping file
K. Enter price data	Y. Aged trial balance
L. Determine that customer exists	Z. Open order file
M. Match customer purchase order with sales order	
N. Perform customer credit check	
O. Prepare sales journal	
P. Prepare sales invoice	

(AICPA, adapted)

Trendel Corporation



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Audit Sampling

In Chapter 5, we discussed the auditors' need for sufficient appropriate evidence as the basis for audit reports. This evidence is sometimes obtained through selecting samples of transactions (or balances) and performing auditing procedures only on those items, rather than on the entire underlying population of items. As we discuss in Chapters 5 and 7, data analytic approaches are reducing the need for audit sampling as auditors are able to economically audit certain entire populations. For example, if auditors wish to test approval of purchases transactions, when that approval is electronically indicated it may be possible to perform an electronic search of all transactions during the year for indication of approval. Nonetheless, sampling of certain populations remains a commonly used approach for certain tests in virtually all audits.

LO 9-1

Distinguish between sampling and nonsampling risk.

Audit sampling, whether statistical or nonstatistical, is the process of selecting and evaluating a sample of items from an audit **population** such that the auditors expect the sample to be representative of some characteristic of the population. In this context, **representative** means that the conclusions from the sample results will be similar to those that would be drawn if the same procedures were applied to the entire population. Basic to audit sampling is **sampling risk**—the risk that the auditors' conclusion based on a sample might be different from the conclusion they would reach if they examined every item in the entire population. That is, for example, the sampling results may lead the auditors to conclude that a population is not materially misstated when, in fact, it is materially misstated.

Sampling risk is *reduced* by increasing the size of the sample. At the extreme, when an entire population is examined, there is no sampling risk. When auditors audit only a sample from a population, they in essence balance acceptance of a degree of sampling risk against the audit efficiency of auditing a fewer number of items. Also, this reliance upon sampling procedures is one of the basic reasons that audit reports are regarded as expressions of opinion with auditors having obtained reasonable assurance, rather than absolute assurance of the fairness of financial statements.

Auditors also may draw erroneous conclusions because of *nonsampling errors*—those due to factors not directly caused by sampling. For example, the auditors may fail to apply appropriate audit procedures, or they may fail to recognize errors in the documents or transactions that are examined. The risk related to nonsampling errors is referred to as **nonsampling risk**. Nonsampling risk can generally be reduced to low levels through effective planning and supervision of audit engagements and implementation of appropriately designed quality management (control) procedures by the CPA firm. The procedures discussed throughout this text help control nonsampling risk. In the remainder of this chapter, we will emphasize the control of sampling risk.

Comparison of Statistical and Nonstatistical Sampling

LO 9-2

Distinguish between statistical and nonstatistical sampling.

Statistical sampling involves the use of an appropriate statistical technique to plan the sample (determine sample size and sample items) and to evaluate sample results. Alternatively,

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 9-1** Distinguish between sampling and nonsampling risk.
- LO 9-2** Distinguish between statistical and nonstatistical sampling.
- LO 9-3** Describe the methods of selecting a representative sample.
- LO 9-4** Understand the different types of sampling plans used in auditing.
- LO 9-5** Explain the effects of changes in various population characteristics and changes in sampling risk on required sample size.
- LO 9-6** Plan, perform, and evaluate samples for tests of controls using attributes sampling.
- LO 9-7** Plan, perform, and evaluate samples for substantive procedures using monetary unit sampling. (Module 9A)
- LO 9-8** Plan, perform, and evaluate samples for substantive procedures using classical variables sampling. (Module 9B)
- LO 9-9** Plan, perform, and evaluate samples for substantive procedures using nonstatistical variables sampling. (Module 9C)

a sample is said to be *nonstatistical* (or judgmental) when the auditors use judgment rather than statistical techniques to plan or evaluate sample results. This is not to say that nonstatistical samples are carelessly selected samples. Indeed, both nonstatistical and statistical audit samples should be selected in a way that they may be expected to allow the auditor to draw valid inferences about the population. In addition, the misstatements found in either a nonstatistical or a statistical sample should be used to estimate the total amount of misstatement in the population (called the **projected misstatement**). However, nonstatistical sampling provides no means of quantifying sampling risk. Thus, the auditors may find themselves taking larger and more costly samples than are necessary, or unknowingly accepting a higher-than-acceptable degree of sampling risk based on a small sample.

The use of *statistical sampling does not eliminate professional judgment* from the sampling process. It does, however, allow the auditors to measure and control sampling risk. Through *statistical sampling* techniques, the auditors may specify in advance the sampling risk that they want in their sample results and then compute a sample size that controls sampling risk at the desired level. Because statistical sampling techniques are based upon the laws of probability, the auditors are able to control the extent of the sampling risk in relying upon sample results. Thus, statistical sampling may assist auditors in (1) designing efficient samples, (2) measuring the sufficiency of the evidence obtained, and (3) objectively evaluating sample results. However, these advantages are not obtained without additional costs of training the audit staff, designing sampling plans, and selecting items for examination. For these reasons, nonstatistical samples are used by auditors, especially for tests of relatively small populations. Both statistical and nonstatistical sampling can provide auditors with sufficient appropriate evidence.¹

Selecting a Random Sample

LO 9-3

Describe the methods of selecting a representative sample.

A common mistake is to equate random sampling and statistical sampling. *Random sampling* is simply a method of selecting items for inclusion in a sample; it can be used in conjunction with either statistical or nonstatistical sampling. To emphasize this distinction, we will use the term **random selection** rather than “random sampling” to refer to the procedure of selecting the items for inclusion in a sample.

The principle involved in unrestricted random selection is that every **sampling unit** (item) in the population has an *equal chance* of being selected for inclusion in the sample.

The sampling unit may be defined in various ways. Consider a year-end account receivable from a customer that is composed of two unpaid purchases (\$20,000 and \$30,000) for a total of \$50,000. The sampling unit often used is the *customer's balance* at a point in time—here there is one sampling unit with a book value of \$50,000. A second approach is to consider the *individual unpaid purchase transactions* as the sampling unit—here there are two sampling units, one of \$20,000 and one of \$30,000. A third approach is to consider *each dollar* the sampling unit—here there are 50,000 sampling units. The approach used by the auditors depends upon a variety of factors, including the nature of the client's information system, the ease of auditing the particular unit, and the sampling technique being used.

Unrestricted random selection requires that every item in the population has an *equal chance* of being selected for inclusion in the sample. Although random selection results in a statistically unbiased sample, it is not necessarily a sample that is representative of the overall population. Sampling risk still exists that purely by chance a sample will be selected that does not possess essentially the same characteristics as the population. However, because the *risk of a nonrepresentative* random sample stems from the laws of probability, this risk may be measured by statistical formulas.

The sample also may not be representative of the actual population because the population being sampled differs from the actual population. The auditors select an audit sample from a **physical representation of the population**. For example, a sample of accounts payable may be selected from an electronic file listing (the physical representation) of

¹ Professional standards (AICPA AU-C 530 and the Audit Guide: Audit Sampling; PCAOB AS 2315) provide auditors with guidelines for planning, performing, and evaluating both statistical and nonstatistical samples.

recorded accounts payable. Any conclusions based on this sample relate only to the population on the computer listing. The auditors' statistical conclusions do not consider the possibility that certain creditors (with balances due) are completely omitted from the listing. Stated in terms of the financial statement assertions, *existence* is addressed to a greater extent than is *completeness*. Therefore, it is essential that the auditors consider whether the physical representation reflects the proper population.

The concept of a random sample requires that the person selecting the sample will *not influence or bias* the selection either consciously or unconsciously. Thus, some type of impartial selection process is necessary to obtain a truly random sample. Techniques often used for selecting random samples include *random number generators*, *random number tables*, and *systematic selection*.

Random Number Generators

Software such as ACL, IDEA, or Excel may be used to generate random numbers. For example, assume that the client's accounts receivable are numbered between 1 and 5,000. The Excel command **=RANDBETWEEN(1,5000)** will produce a random number between 1 and 5,000 to select random accounts.

Random Number Tables

Because of the ease of use of random number generators, tables of random numbers, as illustrated in Figure 9.1, are much less frequently used. In using such a table, the auditors must establish a correspondence between the table numbers and the population being audited, and a starting point in reading the table.

To illustrate the use of a random number table, assume that a client's accounts receivable are numbered from 1 to 5,000 and that the auditors want to select a random sample of 50 accounts for confirmation. Using the table in Figure 9.1, the auditors decide to start at the top of column 2 and to proceed from top to bottom. Reading only the first four digits of the numbers in column 2, the auditors would select 3942, 1968, and 4837 as three of the account numbers to be included in their sample. The next number, 8692, would be ignored because there is no account with that number. The next numbers to be included in the sample would be 1148, 592, 2186, and so on.

Sampling with versus without Replacement

In using either a random number generator or a random number table, there is an issue of the auditors selecting the same number more than once. If they ignore the number the second time it is selected (or use a program that avoids duplicates) and go on to the next number, they are *sampling without replacement*. This term means that an item once selected is not replaced in the population of eligible items, and consequently cannot be drawn for inclusion in the sample a second time.

The alternative to sampling without replacement is sampling with replacement. *Sampling with replacement* means that once an item has been selected, it is immediately

FIGURE 9.1
Table of Random
Numbers

Row	Columns				
	(1)	(2)	(3)	(4)	(5)
1	04734	39426	91035	54839	76873
2	10417	19688	83404	42038	48226
3	07514	48374	35658	38971	53779
4	52305	86925	16223	25946	90222
5	96357	11486	30102	82679	57983
6	92870	05921	65698	27993	86406
7	00500	75924	38803	05386	10072
8	34862	93784	52709	15370	96727
9	25809	21860	36790	76883	20435
10	77487	38419	20631	48694	12638

replaced into the population of eligible items and may be selected a second time. When applied to a random number table, the procedure is to include the number in the analysis as frequently as it occurs in the sample.

Statistical formulas can be used to compute sample size either with or without replacement. Most frequently auditors use sampling without replacement. This results in a *slightly smaller* required sample size and eliminates questions about the propriety of including items more than once in evaluating the sample results.

Systematic Selection

Systematic selection involves selecting *every nth item* in the population following one or more random starting points. To illustrate systematic selection, assume that auditors wish to examine 200 paid checks from a population of 10,000 checks. If only one random starting point were used, the auditors would select every 50th check ($10,000 \div 200$) in the population. As a starting point, the auditors would select at random one of the first 50 checks. If the random starting point is check No. 37, check Nos. 37, 87 ($37 + 50$), and 137 ($87 + 50$) would be included in the sample, as well as every 50th check number after 137.

If the auditors had elected to use five random starting points, 40 checks ($200 \div 5$) would have to be selected from each random start. Thus, the auditors would select every 250th check number ($10,000 \div 40$) after each of the five random starting points between 1 and 250.

Selecting every *nth* item in the population will *not* necessarily result in a random sample when positions in the population are assigned in other than a random order. For example, if expensive inventory parts are always assigned an identification number ending in 9, systematic selection could result in a *highly biased sample* that would include too many expensive items or too many inexpensive items.

To prevent drawing a nonrandom or biased sample when systematic selection is used, the auditors should first attempt to determine whether the population is arranged in random order. If the population is not in random order, the auditors should use multiple random starting points for their systematic selection process.

The systematic selection technique has the advantage of enabling the auditors to obtain a sample from a population of unnumbered documents or transactions. If the documents to be examined are unnumbered, there is no necessity under this method to number them either physically or mentally, as required under the random number table selection technique. Rather, the auditors merely count off the sampling interval to select the documents or use a ruler to measure the interval. However, much more likely is the use of generalized audit software packages that include routines for systematic selection of audit samples from computer-based files.

Other Methods of Sample Selection

Two other selection techniques that are used by auditors include *haphazard selection* and *block selection*. Neither of these two methods applies probabilistic methods to selecting the items for the sample. For that reason, they should not generally be used in conjunction with statistical sampling plans.

Haphazard Selection

When haphazard sample selection is used, the auditors select the items from the population on an *arbitrary basis*, but without any conscious bias. For example, a haphazard sample of paper **vouchers** contained in a file drawer might be selected by pulling vouchers from the drawer without regard for the voucher's size, shape, or location in the drawer. If used, a haphazard sample should not consist of items selected in a careless manner; the sample should be expected to be representative of the population.

Block Selection

A block sample consists of all items in a selected time period, numerical sequence, or alphabetical sequence. For example, in testing internal control over cash disbursements, the auditors might decide to vouch all disbursements made during the months of April and December. In this case, the sampling unit is months rather than individual transactions. Thus, the sample consists of two blocks selected from a population of 12. Due to

the relatively large number of blocks needed to form a reasonable audit conclusion, block sampling cannot generally be relied upon to efficiently produce a representative sample.

Stratification

Auditors often stratify a population before computing the required sample size and selecting the sample. **Stratification** is the technique of dividing a population into relatively homogeneous subgroups called *strata*. These strata then may be sampled separately; the sample results may be evaluated separately, or combined, to provide an estimate of the characteristics of the total population. Whenever items of extremely high or low values or other unusual characteristics are segregated in this manner, each stratum becomes more homogeneous. Ordinarily, the effect is to *require a smaller number of sample items* to evaluate the several strata separately than to evaluate the total population without the use of stratification.

Besides increasing the efficiency of sampling procedures, stratification enables auditors to relate sample selection to the materiality or other characteristics of items and, possibly, to apply different audit procedures to each stratum. For example, in selecting accounts receivable for confirmation (discussed in detail in Chapter 11), auditors might stratify and test the population as follows:

Stratum	Composition of Stratum	Number of Accounts (Method of Selection Used)
1	Accounts of \$10,000 and over	All accounts
2	Accounts of \$5,000 to \$9,999.99	50 accounts (random number generator)
3	Accounts of less than \$5,000	30 accounts (random number generator)

When the auditors are using audit sampling for substantive testing, stratification is almost always applied. For example, the auditors generally will not accept sampling risk for any item that by itself could materially misstate the population as well as other items considered to be high risk of misstatement due to error or fraud—the AICPA *Audit Sampling Guide* refers to these as **individually significant items**. For that reason, the auditors will test every item with a book balance of more than the tolerable misstatement and other high-risk items. They will then select samples from the other items.

Types of Statistical Sampling Plans

LO 9-4

Understand the different types of sampling plans used in auditing.

The sampling procedures used to accomplish specific audit objectives are called *sampling plans*. Statistical sampling plans may be used to estimate many different characteristics of a population, but every estimate is of either (1) *an occurrence rate* or (2) *a numerical quantity*. The sampling terms corresponding to occurrence rates and numerical quantities are *attributes* and *variables*, respectively. Specifically, the major types of statistical sampling plans used for audit sampling include the following:

1. **Attributes sampling.** This sampling plan enables the auditors to estimate the rate of occurrence of certain characteristics in the population (e.g., deviations from performance of a prescribed control). **Attributes sampling** frequently is used in performing tests of controls. For example, the auditor might use attributes sampling to estimate the percentage of the cash disbursements processed during the year that were not approved.
2. **Discovery sampling.** This form of attributes sampling is designed to locate at least one deviation (exception) in the population. **Discovery sampling** often is used in situations in which the auditors expect a very low rate of occurrence of some critical deviation. As an example, the auditors might use discovery sampling to attempt to locate a fraudulent cash disbursement.
3. **Monetary unit sampling (MUS).** This technique, which is also referred to as **dollar-unit sampling**, applies attributes sampling theory to develop an estimate of the total dollar amount of misstatement in a population. **Monetary unit sampling** often is used for performing substantive procedures on transactions or balances. MUS sampling

defines the sampling unit as each individual dollar making up the book value of the population. For example, an MUS variables sampling plan might be used to plan, perform, and evaluate a sample of accounts receivable selected for confirmation. A transaction or account is selected for audit if a dollar from that transaction or account is selected from the population. Therefore, each transaction or account has a probability proportional to its size of being selected for inclusion in the sample. MUS sampling is presented in detail in Module 9A.

4. *Classical variables sampling.* As with MUS sampling, these sampling applications most frequently are used to provide an estimate of a dollar amount of misstatement. As would be expected, this technique is primarily used by auditors to perform substantive procedures. Unlike monetary unit sampling, which in concept samples individual dollars, classical variables applications ordinarily define the sampling unit as each transaction or account balance in the population. Frequently used variables sampling plans include **mean-per-unit estimation**, **ratio estimation**, and **difference estimation**. Classical variables sampling is presented in detail in Module 9B.

Sometimes one sampling plan may be used for the *dual purposes* of obtaining evidence about the effectiveness of an internal control and estimating the amount of the account or the misstatement in the account. For example, a **dual-purpose procedure (test)** might be used to evaluate the effectiveness of a control over recording sales transactions and to estimate the total overstatement or understatement of the sales account.²

Allowance for Sampling Risk (Precision)

LO 9-5

Explain the effects of changes in various population characteristics and changes in sampling risk on required sample size.

Whether the auditors' objective is estimating attributes or variables, the sample results may lead to inaccurate inferences about the population. Some degree of **sampling error**—the difference between the actual rate or amount in the population and that indicated by the sample—is usually present. In utilizing statistical sampling techniques, auditors are able to measure and control the risk of material sampling error by deciding on the appropriate levels of sampling risk and the allowance for sampling risk.

The **allowance for sampling risk** is the amount used to create a range, set by + or – limits from the sample results, within which the true value of the population characteristic being measured is likely to lie. For example, assume a sample is taken to determine the occurrence rate of a certain type of deviation from the performance of a control. The sample indicates a deviation rate of 2.1 percent. The sample deviation rate is often referred to as the **point estimate** of the population's deviation rate. We have little assurance that the deviation rate in the population is exactly 2.1 percent, but we know that the sample result probably approximates the population deviation rate. Therefore, using statistical sampling techniques, we may set an interval around the sample result within which we expect the population deviation rate to be. An allowance for sampling risk of ± 1 percent would indicate that we expect the true population deviation rate to lie between 1.1 and 3.1 percent.

The wider the interval we allow, the more confident we may be that the true population characteristic is within it. In the preceding example, an allowance for sampling risk of ± 2 percent would mean that we assume the population deviation rate to be between 0.1 and 4.1 percent. While being more confident that the true population characteristic falls within an interval is desirable, we realize that the increased size of the interval leads to a less precise conclusion.

The allowance for sampling risk may also be used to construct a dollar interval, particularly when using classical variables sampling. For example, we may attempt to establish the total dollar value of receivables within an interval of $\pm \$10,000$. The allowance for sampling risk required by auditors usually is determined in light of the amount of tolerable misstatement. **Tolerable misstatement**, as described in Chapter 6, is materiality for the audit procedure being performed for a particular account. It is equal to or less than

² For audits performed under PCAOB standards, the size of a sample used for a dual-purpose test should be the larger of the two samples that would have been required for the two separate purposes. AICPA standards no longer include this requirement, although the *Audit Sampling* audit guide states that using the larger number will usually be the case.

performance materiality for the account, which is an estimate of the maximum monetary misstatement that may exist in an account that, when combined with the misstatements in other accounts, will not cause the financial statements to be materially misstated.

Sample Size

The size of the sample has a significant effect upon both the allowance for sampling risk and sampling risk. With a very small sample, we cannot have low sampling risk unless we allow a very large allowance for sampling risk (**precision**). As the sample size increases, both sampling risk and the allowance for sampling risk decrease. In other words, the smaller the allowance for sampling risk or the smaller the sampling risk desired by the auditors, the larger the required sample.

Sample size is also affected by certain characteristics of the population being tested. As the population increases in size, the sample size necessary to estimate the population with specified sampling risk and allowance for sampling risk will increase; however, if the population size is above approximately 500, an increase in its size has only a very small effect on the required sample size. In attributes sampling, sample size also increases as the **expected population deviation rate** increases. Finally, in classical variables sampling, greater variability among the item values in the population (a larger **standard deviation**) increases the required sample size.

Audit Sampling for Tests of Controls

LO 9-6

Plan, perform, and evaluate samples for tests of controls using attributes sampling.

Tests of controls are used to determine whether the client's internal control is operating in a way that would prevent or detect material misstatements in the financial statements. As discussed in Chapter 7, audit sampling cannot be used to test the operating effectiveness of all controls. In general, sampling can be used only when performance of the control leaves some *evidence of performance*, such as a completed document, electronic indication, or manual initials of the person performing the procedure. This evidence of performance allows the auditors to determine whether the control was applied to each item included in the sample. The results of tests of controls are most frequently presented in terms of the *rate of deviation* from performance of the prescribed control—also called the **deviation rate**.

A deviation from performance of a control does not necessarily indicate a misstatement of the financial statements. To illustrate the distinction between deviations and financial statement misstatements, assume that the auditors have selected a sample of 50 large cash disbursement vouchers to test for approval by the assistant controller. If the auditors find that 5 of the 50 vouchers were not properly approved, the deviation rate in the sample is 10 percent ($5 \text{ deviations} \div 50 \text{ vouchers}$), but the financial statements may not be misstated. All five vouchers may represent valid cash disbursements that were properly recorded. However, the auditors may conclude from the results of this test that there is a relatively high risk of invalid cash disbursements because the sample results indicate that the assistant controller fails to approve about 10 percent of the vouchers processed. The auditors will use this evidence to increase the assessed level of control risk for the financial statement accounts that are affected by the cash disbursements cycle. Also, existence of the weakness will ordinarily be communicated to management and, if appropriate, to the audit committee. The communication of control-related matters is discussed in Chapter 7.

Sampling Risk for Tests of Controls

When performing tests of controls, the auditors are concerned with two aspects of sampling risk:

1. *The risk of assessing control risk too high.* This risk is the possibility that the sample results will cause the auditors to assess control risk at a higher level than is warranted based on the actual operating effectiveness of the control.
2. *The risk of assessing control risk too low.* This more important risk is the possibility that the sample results will cause the auditors to assess control risk at a lower level than is warranted based on the actual operating effectiveness of the control.

Figure 9.2 illustrates these two aspects of sampling risk for tests of controls.

FIGURE 9.2 Sampling Risk for Tests of Controls

The Test of Controls Sample Indicates:	Actual Extent of Operating Effectiveness of the Control Procedure Is:	
	Adequate for Planned Assessed Level of Control Risk	Inadequate for Planned Assessed Level of Control Risk
Extent of Operating Effectiveness Is Adequate	Correct decision.	Incorrect decision (risk of assessing control risk too low). Implication: Less substantive procedures than necessary (ineffective audit).
Extent of Operating Effectiveness Is Inadequate	Incorrect decision (risk of assessing control risk too high). Implication: More substantive procedures than necessary (inefficient audit).	Correct decision.

The **risk of assessing control risk too high** relates to the *efficiency* of the audit process. When the sample results cause the auditors to assess control risk at a higher level than it actually is, the auditors will perform more substantive procedures than are necessary in the circumstance. This unnecessary testing reduces the efficiency of the audit, but it does not lessen the *effectiveness* of the audit as a means of detecting material misstatements in the client's financial statements. For that reason, the auditors usually do not attempt to directly control the risk of assessing control risk too high.

The **risk of assessing control risk too low** is of utmost concern. If the auditors assess control risk to be lower than it actually is, they will inappropriately reduce the extent of their substantive procedures. This unwarranted reduction in substantive procedures lessens the overall *effectiveness* of the audit as a means of detecting material misstatements in the client's financial statements. Therefore, the auditors carefully control the risk of assessing control risk too low when performing tests of controls.

In attributes sampling, the **confidence level** is the complement of the risk of assessing control risk too low. Accordingly, if the risk of assessing control risk too low is .05, the confidence level is .95. Thus, a statement that the confidence level of a control is .95 is equivalent to a statement that the risk of assessing control risk too low is .05. The AICPA's *Audit Sampling Guide* currently uses both of these terms to discuss sampling risk.

Attributes Sampling

As indicated previously, attributes sampling is widely used for tests of controls when auditors are estimating the rate of deviations from prescribed controls. For example, if an attributes sample indicates a deviation rate of 5 percent with an allowance for sampling risk of ± 3 percent, the auditors could infer that between 2 and 8 percent of the items in the population contain deviations. In this example, 2 percent is the *lower deviation rate* (lower precision limit) and 8 percent is the *upper deviation rate* (upper precision limit) for the sample estimate. Tests of controls are designed to provide the auditors with assurance that deviation rates do not exceed acceptable levels. Therefore, the auditors are concerned only with the upper deviation rate for the sample estimate. The relevant question from the above example is whether the auditors can accept a deviation rate as high as 8 percent, not whether they can accept a deviation rate as low as 2 percent. The lower deviation rate is not pertinent to the objective of the test. For this reason, auditors generally use one-sided tests in attributes sampling; they consider only the upper deviation rate that will permit them to assess control risk at the planned level. In tests of controls, the upper deviation rate is called the **tolerable deviation rate**.

Attributes sampling for tests of controls generally involves the following 10 steps:

1. Determine the objective of the test.
2. Define the attributes and deviation conditions.

3. Define the population to be sampled.
4. Specify the risk of assessing control risk too low and the tolerable deviation rate.
5. Estimate the expected population deviation rate.
6. Determine the sample size.
7. Select the sample.
8. Test the sample items.
9. Evaluate the sample results.
10. Document the sampling procedure.

Determine the Objective of the Test

The objective of tests of controls is to provide evidence about the design or operating effectiveness of internal control. The auditors perform tests of controls when the audit plan includes an expectation that controls operate effectively. That is, tests of controls are performed when the audit plan includes assessing control risk below the maximum level for one or more financial statement assertions. Accordingly, an attributes sample will be selected and tested to provide audit evidence that a particular control is operating effectively in order to support the auditors' planned assessed level of control risk.

Define the Attributes and Deviation Conditions

The auditors use professional judgment to define the attributes and deviation conditions for a particular test of controls. Attributes are characteristics that provide evidence that a control was actually performed. An example is the existence of the initials of the individual performing the control on the appropriate document. When a sample item does not have one or more of the attributes, it is classified as a deviation. As an example, assume that the auditors are performing a test of controls for the valuation of sales transactions. One of the controls that they decide to test is the review of sales invoices that is performed by an accounting clerk. The clerk's review includes (1) comparing quantities on each invoice to shipping documents, (2) comparing prices on each invoice to authorized price lists, (3) testing the clerical accuracy of each invoice, and (4) initialing a copy of the invoice to indicate that the procedure was performed. In performing the test of this control, the auditors will classify a transaction as a deviation if any one or more of the following deviation conditions exist:

1. The quantities on the invoice do not agree with the shipping documents.
2. The prices on the invoice do not agree with authorized price lists.
3. The invoice has a clerical inaccuracy.
4. The invoice copy is not initialed by the accounting clerk.

It is important that the attributes and deviation conditions be precisely defined before the test of control is performed; otherwise, a staff accountant may not make the appropriate decision about which sample items represent deviations.

If a document selected for testing cannot be located, the auditors generally will not be able to apply alternate procedures to determine whether the control was applied. Simply selecting another item is not appropriate. In such circumstances, at a minimum, the misplaced document should be treated as a deviation for evaluation purposes and documented. Also, because the disappearance of documents is consistent with many possible explanations, ranging from unintentional misfiling to material fraud, the auditors should carefully consider the overall implications of the situation.

Define the Population

The auditors should determine that the population from which the sample is to be selected is appropriate for the specific audit objective. For example, if the auditors wish to test the operating effectiveness of a control designed to ensure that all shipments have been recorded as sales, they will not select a sample from the sales journal—that population is created by recorded sales and could not be expected to contain shipments that were not recorded. The appropriate population for detecting such deviations would be a population that contains all of the items shipped (e.g., the file of shipping documents).

Specify the Risk of Assessing Control Risk Too Low and the Tolerable Deviation Rate

How do auditors determine the appropriate risk of assessing control risk too low and the tolerable deviation rate for a test of a control? The answer, in short, is professional judgment. The risk of assessing control risk too low—that is, the risk that the actual deviation rate exceeds the tolerable deviation rate—is a critical risk in tests of controls. As discussed previously, this risk impacts the effectiveness of the audit. Because the results of tests of controls play a major role in determining the nature, timing, and extent of other audit procedures, auditors usually specify a low level of risk—for example, 5 or 10 percent.

Auditors specify the tolerable deviation rate based on (1) their planned assessed level of control risk and (2) the degree of assurance desired from the audit evidence in the sample. The lower the planned assessed level of control risk (or the more assurance desired from the sample), the lower the tolerable deviation rate.

When determining a tolerable deviation rate for a specific control, auditors consider the planned assessed level of control risk. In general, the lower the planned assessed level of control risk, the lower the tolerable deviation rate. Historically, AICPA guidance included the table below to illustrate the relationship. While the table is no longer in AICPA guidance, we provide it to illustrate the relationship and for use in several of the exercises and problems at the end of the chapter. Know, however, that there is no mathematical basis for these tolerable deviation rates, and historically these rates were developed for manual controls, as contrasted to electronically programmed controls. Also, the overlapping ranges make clear the need for the exercise of professional judgment.

Planned Assessed Level of Control Risk	Tolerable Deviation Rate
Low	2–7%
Moderate	6–12%
Slightly below the maximum	11–20%
Maximum	Omit test

Estimate the Expected Population Deviation Rate

In addition to the tolerable deviation rate and the risk of assessing control risk too low, the expected population deviation rate also affects the sample size in attributes sampling. This expected deviation rate is significant because it represents the rate that the auditors expect to discover in their sample from the population.

In estimating the expected population deviation rate, the auditors often use the sample results from prior years, as documented in their working papers. The auditors may also estimate the rate based on their experience with similar tests on other audit engagements or by examining a small pilot sample.

Determine the Sample Size

As indicated earlier, the three major factors that determine the sample size for a test of a control are the *risk of assessing control risk too low*, the *tolerable deviation rate*, and the *expected population deviation rate*. The population size also has an effect on sample size, but only when the population is very small. Figure 9.3 summarizes the effects of these factors on the required sample size for a test of controls.

Tables to Determine Sample Size

To enable auditors to use attributes sampling without resorting to complex mathematical formulas, tables such as the one in Figure 9.4 have been developed.

Figure 9.4 may be used to determine required sample sizes at 5 percent risk of assessing control risk too low. Similar tables are available for other levels of risk, such as 1 percent and 10 percent. The horizontal axis of the table is the tolerable deviation rate specified by the auditors. The vertical axis is the expected deviation rate estimated by the auditors to exist within the population. The numbers in the body of the table indicate the required sample sizes. The number in parentheses shown after the required sample size is

FIGURE 9.3
Factors Affecting
Sample Size for Tests of
Controls

Factor	Change in Factor	Effect upon Required Sample Size
Auditors' Acceptable:		
Risk of assessing control risk too low	Increase	Decrease
Tolerable deviation rate	Increase	Decrease
Population Characteristics:		
Population deviation rate (expected)	Increase	Increase
Population size	Increase	Increase (if population is small)

the allowable number of deviations that may be observed in the sample for the results to support the auditors' planned assessed level of control risk.³

To use Figure 9.4, the auditors stipulate the expected deviation rate in the population and the tolerable deviation rate.⁴ Then, the auditors read the sample size from the table at the intersection of the stipulated tolerable deviation rate and the expected population deviation rate. For example, assume the auditors expect the deviation rate in the population to be

FIGURE 9.4 Statistical Sample Sizes for Tests of Controls at 5 Percent Risk of Assessing Control Risk Too Low (with Allowable Number of Deviations in Parentheses)

Expected Population Deviation Rate (as Percentages)	Tolerable Deviation Rate										
	2%	3%	4%	5%	6%	7%	8%	9%	10%	15%	20%
0.00%	149(0)	99(0)	74(0)	59(0)	49(0)	42(0)	36(0)	32(0)	29(0)	19(0)	14(0)
0.25	236(1)	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
0.50	*	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
0.75	*	208(2)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.00	*	*	156(2)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.25	*	*	156(2)	124(2)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.50	*	*	192(3)	124(2)	103(2)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.75	*	*	227(4)	153(3)	103(2)	88(2)	77(2)	51(1)	46(1)	30(1)	22(1)
2.00	*	*	*	181(4)	127(3)	88(2)	77(2)	68(2)	46(1)	30(1)	22(1)
2.25	*	*	*	208(5)	127(3)	88(2)	77(2)	68(2)	61(2)	30(1)	22(1)
2.50	*	*	*	*	150(4)	109(3)	77(2)	68(2)	61(2)	30(1)	22(1)
2.75	*	*	*	*	173(5)	109(3)	95(3)	68(2)	61(2)	30(1)	22(1)
3.00	*	*	*	*	195(6)	129(4)	95(3)	84(3)	61(2)	30(1)	22(1)
3.25	*	*	*	*	*	148(5)	112(4)	84(3)	61(2)	30(1)	22(1)
3.50	*	*	*	*	*	167(6)	112(4)	84(3)	76(3)	40(2)	22(1)
3.75	*	*	*	*	*	185(7)	129(5)	100(4)	76(3)	40(2)	22(1)
4.00	*	*	*	*	*	*	146(6)	100(4)	89(4)	40(2)	22(1)
5.00	*	*	*	*	*	*	*	158(8)	116(6)	40(2)	30(2)
6.00	*	*	*	*	*	*	*	*	179(11)	50(3)	30(2)
7.00	*	*	*	*	*	*	*	*	*	68(5)	37(3)

Note: This table assumes a large population.

* Sample size is too large to be cost-effective for most audit applications.

Source: AICPA, *Audit Guide, Audit Sampling* (New York, 2017).

³ The number of deviations allowable in a sample sometimes exceeds the expected deviation rate multiplied by the sample size. This is because the allowable number of deviations is always rounded to the nearest whole number because it is not possible to observe a partial deviation in a sample item. The sample sizes have been adjusted to reflect this rounding.

⁴ Some tables require the auditors to specify population size. Figures 9.4 and 9.5 assume an infinite population. When populations are small, required sample sizes are only slightly smaller.

1 percent and specify a 9 percent tolerable deviation rate to justify their planned assessed level of control risk related to this control. Figure 9.4 shows that these specifications result in a sample size of 51 items, which must contain no more than 1 control deviation if the auditors' planned control risk assessment is to be supported by the test.

The various tables are ordinarily applied in situations in which various controls operate frequently (e.g., controls over sales transactions). Some controls that the auditors test operate infrequently. For example, controls over the year-end closing process may only occur once a year and can only be tested once. Other controls operate weekly (e.g., payroll), monthly (e.g., certain adjusting entries), or quarterly (e.g., quarterly closing process). The AICPA suggests the following frequency of testing of such controls in circumstances in which the test may not be the sole source of evidence related to the control objective(s) involved:

Frequency of Control Operation	Sample Size
Weekly	5–9
Monthly	2–4
Quarterly	2

Select the Sample

When the auditors use attributes sampling, it is essential that the sample items be selected in a manner that achieves a random sample. Random samples may be selected using random number tables, random number generators, or systematic sampling. When selecting the sample items, the auditors often select extra items to be substituted for any voided, unused, or inapplicable items. An inapplicable item is one that would not be expected to have a particular attribute. For example, assume the auditors are testing a sample of cash disbursement transactions to determine that they are all supported with receiving reports. If a rent payment is selected, the item would be inapplicable because it would not be expected to be supported with a receiving report.

Test the Sample Items

When testing the sample items, an auditor ordinarily examines each sample item for the attributes of interest. Each item will be classified as to whether it contains a deviation from the prescribed control. The auditor performing the test also should be alert for evidence of any unusual matters, such as evidence of fraud (e.g., suspicious alteration of a document) or related party transactions.

While auditors usually examine each item in the sample, in some situations they may find a relatively large number of deviations in the first items examined and determine that, even if no additional deviations were to be discovered in the remainder of the sample, the results of the sample would not support the planned assessed level of control risk. In such circumstances, the auditors may reassess the level of control risk and consider whether it is appropriate to continue the test.

Evaluate the Sample Results

After testing the sample items and summarizing the deviations from a prescribed control, the auditors evaluate the sample results. In evaluating the results, the auditors should consider not only the actual number of deviations observed, but also the nature of the deviations. The auditors' evaluation will include the following four steps:

1. *Determine the deviation rate.* Calculating the deviation rate in the sample involves dividing the number of observed deviations by the sample size.
2. *Determine the achieved upper deviation rate.* The auditors will use computer software or a table to determine the achieved upper deviation rate (also referred to as the achieved upper precision limit). This deviation rate represents the maximum population deviation rate that the auditors can expect based on the results of the sample.
3. *Consider the qualitative aspects of the deviations.* In addition to considering the deviation rate in the sample, the auditors will consider the nature of the deviations and any

implications for other phases of the audit. Deviations that result from intentional acts (fraud) are of much more concern than those that are due to a misunderstanding of instructions or carelessness. For example, if only one unapproved invoice is identified, yet it indicates management fraud, the implications ordinarily will be much more serious than an unapproved invoice that was simply overlooked and, while not approved, represents a valid business expense.

4. *Reach an overall conclusion.* The auditors will consider the sample evidence with the results of other relevant tests of controls to determine whether the combined results indicate that the **risks of material misstatement** are unacceptably high or indicate support for the planned assessed level of control risk. As indicated in the previous step, when important qualitative aspects of one or more deviations have been identified, the likely implications must be considered, regardless of quantitative computations. When no problematical qualitative aspects are involved, the process is one of concluding on the importance of the exceptions identified and with whether the actual rate of deviation in the population is likely to exceed the tolerable rate of deviation.

To illustrate the above, assume that the auditors have established 7 percent as a tolerable misstatement level and have a 2 percent deviation rate in their sample. The statistical issue is whether it is safe to conclude that the population deviation rate is less than 7 percent, given a sample with a deviation rate of 2 percent. If the auditors find that the sample results statistically support a conclusion that the population's deviation rate is less than 7 percent, they will consider whether other available relevant audit evidence also supports the planned level of controls reliance. If the sample does not support a conclusion that the deviation rate is less than 7 percent, the auditors ordinarily will increase the assessed level of control risk, which may result in the need to decrease detection risk by increasing the scope of planned substantive procedures.

Tables to Evaluate Sample Results

The tables presented in this chapter may be used to evaluate sample results in two different, but related, ways. The first approach is to use Figure 9.4. When the number of deviations found in the sample does not exceed the allowable number of deviations (the parenthetical number in Figure 9.4), the auditors conclude that the population's deviation rate does not exceed the tolerable deviation rate. Therefore, the results support the auditors' planned assessed level of control risk. On the other hand, when the number of deviations found in the sample exceeds the allowable number of deviations, the auditors conclude that the population's deviation rate exceeds the tolerable deviation rate and therefore they should generally increase their assessed level of control risk.

The second approach for evaluating sample results is to use Figure 9.5. This approach allows auditors to obtain a more precise conclusion—one that includes determining the achieved upper deviation rate. The achieved upper deviation rate is the maximum deviation rate that is supported by the sample results. When the achieved upper deviation rate is more than the tolerable deviation rate, the planned assessed level of control risk relating to the control is not supported.

To illustrate the second approach for evaluation of a sample, assume that two deviations are found in the sample of 51. As indicated previously, the auditors selected this sample with a specified risk of assessing control risk too low of 5 percent, a tolerable deviation rate of 9 percent, and an expected population deviation rate of 1 percent. A maximum of 1 deviation was allowable. Referring to Figure 9.5, we find that the exact sample size of 51 does not appear. When this happens, the auditors may interpolate; use more detailed tables, sometimes generated by a computer program; or use the largest sample size listed on the table that does not exceed the sample size actually selected. Using the latter approach, the auditors evaluate the results using a slightly smaller size of 50. Figure 9.5 indicates that when 2 deviations are found in a sample size of 50, the achieved upper deviation rate is 12.1 percent. This tells the auditors that, statistically, there is a 5 percent chance that the actual deviation rate is higher than 12.1 percent, but this exceeds the 9 percent tolerable deviation rate. The most likely effect of this sample result will

FIGURE 9.5 Statistical Sampling Results Evaluation Table for Tests of Controls: Achieved Upper Deviation Rate at 5 Percent Risk of Assessing Control Risk Too Low

Sample Size	Actual Number of Deviations Found										
	0	1	2	3	4	5	6	7	8	9	10
25	11.3	17.6	*	*	*	*	*	*	*	*	*
30	9.5	14.9	19.6	*	*	*	*	*	*	*	*
35	8.3	12.9	17.0	*	*	*	*	*	*	*	*
40	7.3	11.4	15.0	18.3	*	*	*	*	*	*	*
45	6.5	10.2	13.4	16.4	19.2	*	*	*	*	*	*
50	5.9	9.2	12.1	14.8	17.4	19.9	*	*	*	*	*
55	5.4	8.4	11.1	13.5	15.9	18.2	*	*	*	*	*
60	4.9	7.7	10.2	12.5	14.7	16.8	18.8	*	*	*	*
65	4.6	7.1	9.4	11.5	13.6	15.5	17.4	19.3	*	*	*
70	4.2	6.6	8.8	10.8	12.6	14.5	16.3	18.0	19.7	*	*
75	4.0	6.2	8.2	10.1	11.8	13.6	15.2	16.9	18.5	20.0	*
80	3.7	5.8	7.7	9.5	11.1	12.7	14.3	15.9	17.4	18.9	*
90	3.3	5.2	6.9	8.4	9.9	11.4	12.8	14.2	15.5	16.8	18.2
100	3.0	4.7	6.2	7.6	9.0	10.3	11.5	12.8	14.0	15.2	16.4
125	2.4	3.8	5.0	6.1	7.2	8.3	9.3	10.3	11.3	12.3	13.2
150	2.0	3.2	4.2	5.1	6.0	6.9	7.8	8.6	9.5	10.3	11.1
200	1.5	2.4	3.2	3.9	4.6	5.2	5.9	6.5	7.2	7.8	8.4

Note: This table presents upper limits as percentages. This table assumes a large population.

* Over 20 percent.

Source: AICPA, *Audit Guide: Audit Sampling* (New York, 2017).

be an increase in the assessed level of control risk, with a corresponding increase in the scope of substantive testing for the related financial statement assertions. Only when the upper deviation rate found in Figure 9.5 is less than or equal to the tolerable deviation rate would the sample results support the auditors' planned assessed level of control risk.

Document the Sampling Procedure

Finally, the auditors will document the significant aspects of the prior nine steps in the working papers. This documentation should include an identification of the selected items.

Detailed Illustration of Attributes Sampling

The following procedures for applying attributes sampling are based upon the use of the tables in Figures 9.4 and 9.5; however, only slight modifications of the approach are necessary if other tables are used.

1. *Determine the objective of the test.* Assume that the auditors wish to test the effectiveness of the client's control of matching receiving reports with purchase invoices as a step in authorizing payments for purchases of materials. They are interested in the clerical accuracy of the matching process and in determining whether the control that requires the matching of purchase invoices and receiving reports is operating effectively.

2. *Define the attributes and deviation conditions.* The auditors define the deviation conditions as any one or more of the following with respect to each invoice and the related receiving report:

- Any invoice not supported by a receiving document.
- Any invoice supported by a receiving document that is applicable to another invoice.
- Any difference between the invoice and the receiving document as to quantities received.

For this test, the only procedure required is inspection of the documents and matching of the receiving reports with invoices.

3. *Define the population to be sampled.* The client prepares a serially numbered voucher for every purchase of materials. The receiving report and purchase invoice are

attached to each voucher. Therefore, the **sampling unit** for the test is an individual voucher. Because the test of controls is being performed during the interim period, the population to be tested consists of 3,653 vouchers for purchases of material during the first 10 months of the year under audit. If at any point the auditor determines that the physical representation of the population (the 3,653 vouchers) has omitted vouchers that should be included in the first 10 months, the auditors should also test those vouchers.

4. *Specify the risk of assessing control risk too low and the tolerable deviation rate.* The auditors realize that errors in matching receiving reports with purchase orders can affect the financial statements through overpayments to vendors and misstatements of purchases and accounts payable. They also plan to assess control risk at a low level for the assertions of existence, occurrence, and valuation of purchases, inventories, and accounts payable. Based on these considerations, the auditors decide upon a tolerable deviation rate of 7 percent, with a 5 percent risk of assessing control risk too low.

5. *Estimate the expected population deviation rate.* In the audits of the previous three years, the auditors observed that exceptions for the test described above produced deviation rates of 1.2, 1.3, and 1.1 percent. Therefore, the auditors conservatively select an expected deviation rate of 1.5 percent.

6. *Determine the sample size.* Because the stipulated risk of assessing control risk too low is 5 percent, Figure 9.4 is applicable. At the intersection of the column for a tolerable deviation rate of 7 percent and the row for a 1.5 percent expected deviation rate, the sample size is found to be 66 items. The allowable number of deviations in the sample is 1.

7. *Select the sample.* Because the vouchers are serially numbered, the auditors decide to use a generalized audit software program to generate a list of random numbers to select the sample for testing.

8. *Test the sample items.* The auditors proceed to examine the vouchers and supporting documents for each of the types of deviations previously defined. As they perform the test, the auditors will be alert for any unusual matters, such as evidence of fraud.

During the process of testing the sample items, a question may arise as to whether certain situations represent deviations, including:

- *Inability to examine selected items.* In some circumstances the auditors may find that support cannot be located. For example, although the voucher itself seems to indicate evidence of a receiving report (e.g., a receiving report number listed), the receiving report itself is unavailable. The transaction should be considered a deviation, and the auditor should consider the effect of the limitation on their understanding of internal control and assessment of control risk and audit risk. A difficulty here is that such a situation might be due to a range of circumstances from an inappropriately deleted (or misfiled) document to fraud. The auditors should attempt to apply alternate procedures to determine propriety of the transaction and consider why this circumstance of a missing receiving report exists and carefully consider possible implications of the situation.
- *Voided documents.* Assume that a selected voucher was voided—that is, not included because at some point the purchase process was stopped prior to receiving the goods. If that voucher is properly voided, absent other circumstances, it would not represent a deviation from the control being tested. The auditors would replace it with another randomly selected voucher.
- *Inapplicable sample items.* Sometimes a selected item is inapplicable for a given definition of a deviation. For example, the auditors may find that their sample includes a service expenditure (e.g., utilities bill) for which a receiving report is not appropriate. Ordinarily it is best to exclude such items prior to sampling and perform other tests on them as necessary. But here, the auditors have selected a voucher that lacks a receiving report, ordinarily a deviation. Because no receiving report is expected, it does not represent a deviation from the control being tested. Unless the transaction in some form seems inappropriate, it should not be considered a deviation and should be replaced by another randomly selected voucher. In a similar situation, the auditors' sample may include an appropriately unused voucher; the item should also be replaced in the sample.

9. *Evaluate the sample results.* In evaluating the sample results, the auditors consider not only the actual number of deviations observed, but also the nature of the deviations. We will discuss three possible situations: (a) the actual number of deviations is equal to or less than the allowable number, (b) the actual number of deviations is more than the allowable number, and (c) one or more deviations observed contain evidence of a deliberate manipulation or circumvention of internal control.

To illustrate situation (a), assume that no deviation is identified. Recall that the allowable number of deviations from Figure 9.4 is 1. Because the number of deviations (here, none) does not exceed the allowable number, the auditors may conclude that there is less than a 5 percent risk that the population deviation rate is greater than 7 percent, the tolerable rate. In this case, the sample results support the auditors' planned assessed level of control risk. Alternatively, using the second approach and referring to Figure 9.5, for a sample size of 65 (the highest number still less than the actual sample size), the auditors find that when zero deviations are observed, the achieved upper deviation rate is 4.6 percent. The rule is simple: Absent qualitative considerations that affect the decision, when the achieved upper deviation rate is lower than the tolerable deviation rate, the results support the auditors' planned assessed level of control risk. In this situation, this is the case because the achieved upper deviation rate of 4.6 is less than the tolerable rate of 7 percent.

For situation (b), assume that the number of deviations observed in the sample is 3, and none of the observed deviations indicate deliberate manipulation or circumvention of internal control. Using the first approach for evaluating results presented earlier, because this exceeds the allowable 1 deviation, the auditors simply conclude that the achieved upper deviation rate is greater than 7 percent. Or, if they wish to use the second approach for evaluating results, they may use Figure 9.5 to find that the achieved upper deviation rate is 11.5 percent. In light of these results (the achieved upper deviation rate of 11.5 percent exceeds the tolerable deviation rate of 7 percent), the auditors should increase the assessed level of control risk in this area and increase the extent of their substantive testing procedures to decrease detection risk.

Finally, for situation (c), assume that one or more of the deviations discovered by the auditors indicates a deliberate circumvention of controls indicative of possible fraud. In such a circumstance, other auditing procedures become necessary. The auditors should evaluate the effect of the deviation on the financial statements and adopt auditing procedures that are specifically designed to detect the type of deviation observed. Indeed, the nature of the deviation may be more important than its rate of occurrence. As a preliminary step to any modification of their audit plan, the auditors should investigate the cause of the unexpectedly high deviation rate. To illustrate, if they find that a receiving report was not prepared for a purchase from a particular supplier, they might expand their sample to include other, or all, purchases from that vendor. Or, through a data analytical approach, they might search for all disbursements lacking a receiving report and try to identify any patterns in the identified deviations.

10. *Document the sampling procedures.* Finally, each of the nine prior steps, as well as the basis for overall conclusions, should be documented in the auditors' working papers. Figure 9.6 is an illustrative working paper that documents the results of this test of controls, as well as tests of other controls for the purchasing cycle.

Other Statistical Attributes Sampling Approaches

Discovery Sampling

Discovery sampling is actually a modified case of attributes sampling. The purpose of a discovery sample is to detect at least 1 deviation, with a predetermined risk of assessing control risk too low if the deviation rate in the population is greater than the specified tolerable deviation rate. One important use of discovery sampling is to locate examples of a suspected fraud.

Although discovery sampling is designed to locate relatively rare items, it cannot locate a needle in a haystack. If an extremely small number of deviations exist within a population (e.g., 0.1 percent or less), no sample of reasonable size can provide adequate

FIGURE 9.6 Documentation of the Results of Tests of Controls

SCANTECH INC. Attributes Sampling Summary—Purchase Transactions December 31, 20X2																																			
Objectives of test: (1) To test the operating effectiveness of the procedures for matching receiving reports with purchase invoices; (2) to test the operating effectiveness of the procedures for matching purchase orders with purchase invoices; (3) to test the operating effectiveness of the procedures for testing the clerical accuracy of purchase invoices.																																			
Population: Voucher register entries for the first 10 months of the year.																																			
Sampling unit: Individual vouchers.																																			
Random selection procedure: Random number generator.																																			
Risk of assessing control risk too low: 5 percent.																																			
<table border="1" style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 30%;"></th><th colspan="3">Planning Parameters:</th><th colspan="2">Sample Results:</th></tr> <tr> <th>Attributes Tested:</th><th>Tolerable Deviation Rate</th><th>Expected Deviation Rate</th><th>Sample Size</th><th>Number of Deviations</th><th>Achieved Maximum Rate</th></tr> </thead> <tbody> <tr> <td>1. Quantity and other data on receiving report agree with purchase invoice.</td><td style="text-align: center;">7%</td><td style="text-align: center;">1.5%</td><td style="text-align: center;">66</td><td style="text-align: center;">1</td><td style="text-align: center;">7.1%</td></tr> <tr> <td>2. Prices and other data on purchase order agree with purchase invoice.</td><td style="text-align: center;">10%</td><td style="text-align: center;">1.0%</td><td style="text-align: center;">46</td><td style="text-align: center;">0</td><td style="text-align: center;">6.5%</td></tr> <tr> <td>3. Clerical accuracy of purchase invoice has been verified.</td><td style="text-align: center;">7%</td><td style="text-align: center;">0%</td><td style="text-align: center;">42</td><td style="text-align: center;">0</td><td style="text-align: center;">7.3%</td></tr> </tbody> </table>							Planning Parameters:			Sample Results:		Attributes Tested:	Tolerable Deviation Rate	Expected Deviation Rate	Sample Size	Number of Deviations	Achieved Maximum Rate	1. Quantity and other data on receiving report agree with purchase invoice.	7%	1.5%	66	1	7.1%	2. Prices and other data on purchase order agree with purchase invoice.	10%	1.0%	46	0	6.5%	3. Clerical accuracy of purchase invoice has been verified.	7%	0%	42	0	7.3%
	Planning Parameters:			Sample Results:																															
Attributes Tested:	Tolerable Deviation Rate	Expected Deviation Rate	Sample Size	Number of Deviations	Achieved Maximum Rate																														
1. Quantity and other data on receiving report agree with purchase invoice.	7%	1.5%	66	1	7.1%																														
2. Prices and other data on purchase order agree with purchase invoice.	10%	1.0%	46	0	6.5%																														
3. Clerical accuracy of purchase invoice has been verified.	7%	0%	42	0	7.3%																														
Conclusion: The results support the assessment of a low level of control risk for existence and valuation of purchases, inventory, and accounts payable.																																			

assurance that an example of the deviation will be encountered. Still, discovery sampling can (with a very high degree of confidence) ensure detection of deviations occurring at a rate as low as 0.3 to 1 percent.

Discovery sampling is used primarily to search for critical deviations. When a deviation is critical, such as evidence of fraud, any deviation rate may be intolerable. Consequently, if such deviation is discovered, the auditors may abandon their sampling procedures and undertake a thorough examination of the population. If no deviations are found in discovery sampling, the auditors may conclude (with the specified risk of assessing control risk too low) that the critical deviation does not occur to the extent of the tolerable deviation rate.

To use discovery sampling, the auditors must specify their desired risk of assessing control risk too low and the tolerable deviation rate for the test. The required sample size then may be determined by referring to an appropriate attributes sampling table, with the assumption that the expected deviation rate in the population is 0 percent.

To illustrate discovery sampling, assume that auditors have reason to suspect that someone has been preparing fraudulent purchase orders, receiving reports, and purchase invoices in order to generate cash disbursements for fictitious purchase transactions. In order to determine whether this has occurred, it is necessary to locate only one set of the fraudulent documents in the client's file of paid vouchers.



Assume the auditors desire a 5 percent risk that their sample will not bring to light a fraudulent voucher if the population contains 2 percent or more fraudulent items. Referring to Figure 9.4, the auditors find that a sample size of 149 is required for an expected population deviation rate of 0 percent and a tolerable deviation rate of 2 percent. Assuming that the auditors select and examine the 149 vouchers and no fraudulent vouchers are found, they may conclude that there is only a 5 percent risk that there are more than 2 percent fraudulent vouchers in the population.

Sequential (Stop-or-Go) Sampling

Another approach used in practice is **sequential (stop-or-go) sampling**. Under a sequential sampling plan, the audit sample is taken in several stages. The auditors start by examining a small sample. Then, based on the results of this initial sample, they decide whether to (1) assess control risk at the planned level, (2) assess control risk at a higher level than planned, or (3) examine additional sample items to get more information. If the sample results do not provide enough information to make a clear-cut decision about internal control, the auditors examine additional items and repeat the decision process until the tables being used indicate that a decision as to the assessed level of control risk can be made.

The primary advantage of a sequential approach is that for very low population deviation rates, smaller sample sizes may be required as compared to the fixed-size sample plans. Disadvantages of sequential approaches include the fact that sample sizes may be larger for populations with moderate deviation rates and the process of drawing samples at several stages may not be as efficient.

Nonstatistical Attributes Sampling

The major differences between statistical and nonstatistical sampling in attributes sampling are the steps for determining sample size and evaluating sample results. As is the case with statistical sampling, auditors who use nonstatistical sampling need to consider the risk of assessing control risk too low and the tolerable deviation rate when determining the required sample size. But these factors need not be quantified. In evaluating results, the auditors should compare the deviation rate of the sample to the tolerable deviation rate. If the sample size was appropriate and the sample deviation rate is somewhat lower than the tolerable deviation rate, the auditors can generally conclude that the risk of assessing control risk too low is at an acceptable level. As the sample deviation rate gets closer to the tolerable deviation rate, it becomes less and less likely that the population's deviation rate is lower than the tolerable level. The auditors should use their professional judgment to determine the point at which the assessed level of control risk should be increased above the planned level.

Audit Sampling for Substantive Tests of Details

LO 9-5

Explain the effects of changes in various population characteristics and changes in sampling risk on required sample size.

Substantive procedures are designed to detect misstatements, due to errors or fraud, that may exist in the financial statements. The sampling plans used for substantive tests of details are designed to estimate the dollar amount of misstatement in a particular account balance. Based on the sample results, the auditors then conclude whether there is an unacceptably high risk of material misstatement in the balance. The steps involved may be summarized as

1. Determine the objective of the substantive test of details.
2. Define the population and sampling unit.
3. Choose an audit sampling technique.
4. Determine the sample size.
5. Select the sample.
6. Test the sample items.
7. Evaluate the sample results.
8. Document the sampling procedure.

FIGURE 9.7
Sampling Risk for
Substantive Tests of
Details

The Substantive Test of Details Sample Indicates:	The Population Actually Is:	
	Not Materially Misstated	Materially Misstated
The Population Is Not Materially Misstated	Correct decision.	Incorrect decision (risk of incorrect acceptance). Implication: Possible audit failure to identify material misstatement (ineffective audit).
The Population Is Materially Misstated	Incorrect decision (risk of incorrect rejection) Implication: More substantive procedures than necessary (inefficient audit).	Correct decision

In the modules that follow, we use the above to structure our discussions of the three most frequently used variables sampling approaches, monetary unit sampling (Module 9A), classical variables sampling (Module 9B), and nonstatistical variables sampling (Module 9C). Here we discuss variables sampling risk and factors affecting variables sample size.

Sampling Risk for Substantive Tests of Details

Similar to sampling risk for tests of controls, there are two aspects of sampling risk for substantive tests of details:

1. *The risk of incorrect rejection (alpha risk) of an account.* This is the possibility that sample results will indicate that an account balance is materially misstated when, in fact, it is not misstated.
2. *The risk of incorrect acceptance (beta risk) of an account.* This is the possibility that sample results will indicate that an account balance is not materially misstated when, in fact, it is materially misstated.

The nature of these risks parallels the sampling risks of tests of controls. If the auditors make the first type of error and incorrectly reject an account balance, their audit will lack efficiency because they will perform additional audit procedures that will eventually reveal that the account is not materially misstated. Thus, the risk of incorrect rejection ordinarily does not relate to the effectiveness of the audit.⁵

If the auditors make the second type of error, incorrect acceptance, the effectiveness of the audit is compromised. Therefore, the risk of incorrect acceptance is of primary concern to auditors; failure to detect a material misstatement may lead to accusations of negligence and to extensive legal liability when the auditors issue an inappropriate opinion on materially misstated financial statements. Figure 9.7 illustrates both aspects of sampling risk for substantive procedures.

Sample Size for Substantive Tests of Details

The sample size for a substantive test is affected by the auditors' acceptable sampling risk and tolerable misstatement and by the population characteristics (population size and variability or expected misstatement). Figure 9.8 summarizes the effect of the various factors on the required sample size.

⁵ Audit effectiveness will be negatively affected if incorrect rejection leads to the client recording an improper journal entry to adjust the account to the misstated amount suggested by the auditors' substantive procedures.

FIGURE 9.8 Factors Affecting Sample Size for Substantive Procedures

Factor	Change in Factor	Effect on Required Sample Size
Auditors' Acceptable:		
Risk of incorrect rejection	Increase	Decrease
Risk of incorrect acceptance	Increase	Decrease
Tolerable misstatement	Increase	Decrease
Population Characteristics:		
Population size	Increase	Increase (if population is small)
Population variability as measured by the standard deviation (if classical variables sampling is used)	Increase	Increase
Expected misstatement	Increase	Increase

As indicated previously, the auditors occasionally will design a **dual-purpose procedure (test)** to obtain evidence about the effectiveness of an internal control and to estimate the amount of the account or the misstatement in the account. In these situations, the sample size is generally set at the larger of the sample sizes for the individual tests. This approach is required for audits performed under PCAOB standards.

Variables Sampling Approaches Included in Modules 9A, 9B, and 9C

As indicated earlier in the chapter, in the following three modules, we include coverage of the major types of variables sampling techniques: monetary unit sampling (Module 9A), classical variables sampling (Module 9B), and nonstatistical variables sampling (Module 9C). These techniques may be applied using available software (e.g., firm-specific software, ACL, or IDEA) or manually using a combination of formulas and tables. Our emphasis within each module is to provide formulas and tables, while also covering available software applications.

Monetary Unit Sampling

Monetary unit sampling is very frequently used in practice, both electronically and manually. The technique may be implemented in a variety of ways, each of which generally provides similar results. Our approach in Module 9A emphasizes the use of formulas and tables, which is one of the approaches included in the *AICPA Audit Sampling Guide*.

A monetary unit sample is most frequently selected using a systematic approach that ensures inclusion of all individually significant items. Evaluation of results involves calculating the projected misstatement based on the misstatements identified and an allowance for sampling risk.

Classical Variables Sampling

The three forms of classical variables sampling we discuss are

- *Mean-per-unit estimation.* This method uses the average audited value of the sample to estimate the population value.
- *Difference estimation.* This method uses the difference between sample book values and audited values to estimate the population value.
- *Ratio estimation.* This method uses the ratio of the sample book values to their audited values to estimate the population value.

In practice, the sample for each of the preceding forms is generally taken by randomly selecting population units for inclusion in the sample, often using stratification. Evaluation of results in practice settings involves calculating a projected misstatement and an

FIGURE 9.9 Relative Advantages and Disadvantages of Classical Variables Sampling and Monetary Unit Sampling

Monetary Unit Sampling (MUS)	
Advantages	Disadvantages
1. The technique is generally easier to use. 2. No estimate of the standard deviation of the population is needed. 3. The technique automatically stratifies the population because items are selected based on their dollar amount. 4. When there are few misstatements, the technique will generally result in a smaller sample size. 5. Sample selection can begin before the entire population is available.	1. Special considerations are required to handle understated accounts and negative balances. 2. Each item in the population must have a book value. 3. When misstatements are found, the technique might overstate the allowance for sampling risk. 4. For accounts with a moderate number of misstatements, the sample size may exceed that of the classical techniques.
Classical Variables Sampling	
Advantages	Disadvantages
1. When there are many misstatements in the population, variables sampling techniques will result in a smaller sample size. 2. Items with zero and negative balances do not require any special treatment. 3. Sample size may be somewhat easier to expand if that becomes necessary.	1. To determine the sample size, the standard deviation of the population must be estimated. 2. To evaluate results, the sample's standard deviation must be calculated. 3. Variables sampling (especially mean-per-unit) usually must be stratified, requiring the use of a computer to perform the computations.

allowance for sampling risk. Our emphasis in Module 9B is on the mean-per-unit method, with evaluation of results for difference and ratio estimation limited to the calculation of the projected misstatement.

While Modules 9A and 9B discuss and describe monetary unit sampling and classical variable sampling in detail, at this point we provide a summary of the advantages and disadvantages of each in Figure 9.9.

Nonstatistical Variables Sampling

Nonstatistical variables sampling techniques rely more heavily upon individual auditor judgment in calculating sample size and evaluating results because they do not use statistical methods to measure sampling risk. However, structure is often added to the techniques by using guidelines based on statistical approaches. Module 9C presents nonstatistical variables sampling techniques that use structured approaches for determining sample size and evaluating the results.

Chapter Summary

This chapter presented the concepts and techniques used by auditors to perform audit sampling. To summarize:

1. Audit sampling is defined as applying an audit procedure to less than 100 percent of the items in a population to make some conclusion about that population.
2. Auditors may use statistical or nonstatistical sampling to perform tests of controls or substantive tests of details. Statistical sampling allows the auditors to measure and control sampling risk. Sampling risk is the risk that the auditors will make an incorrect conclusion from the sample results because the sample is not representative of the population.
3. The major type of statistical sampling plan for tests of controls is attributes sampling, which can provide the auditors with an estimate of the rate of the deviations from a prescribed internal control policy or procedure.

4. The two aspects of sampling risk for tests of controls include the risk of assessing control risk too high, which relates to the efficiency of the audit, and the risk of assessing control risk too low, which is critical because it relates to the effectiveness of the audit.
5. The major factors that affect the required sample size for an attributes sample are the risk of assessing control risk too low, the tolerable deviation rate, and the expected deviation rate in the population.
6. The two aspects of sampling risk for substantive tests of details are the risk of incorrect rejection and the risk of incorrect acceptance. The risk of incorrect acceptance is the critical risk because if the auditors accept a materially misstated account balance, they may issue an inappropriate audit opinion.
7. The major factors that affect the required sample size for a variables sample are the risks of incorrect acceptance and rejection, the tolerable misstatement, and population characteristics (population size and expected misstatement). Also, for the classical methods (discussed in detail in Module 9B), it is affected by population variability.
8. Three frequently used variables sampling approaches are monetary unit sampling (discussed in Module 9A), classical variables sampling (Module 9B), and nonstatistical variables sampling (Module 9C). The modules follow the chapter questions and problems.

Key Terms Introduced or Emphasized in Chapter 9, Including Modules and Appendix

Acceptance interval (433) An interval constructed by using the estimated total audited value $\pm$ the allowance for sampling risk. When the population book value is within this interval, the population is accepted as being materially accurate at the planned sampling risks. (Module 9B)

Allowance for sampling risk (ASR) (398) A measure of the difference between sample estimate (projection) and the tolerable rate of deviation or tolerable misstatement at a specified sampling risk. The allowance for sampling risk is also referred to as precision.

Attributes sampling (397) A sampling plan enabling the auditors to estimate the rate of deviation (occurrence) in a population.

Audit risk (450) The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.

Audit sampling (393) Selecting and evaluating less than 100 percent of the population of audit relevance such that the auditor expects the items selected (the sample) to be representative of the population and, thus, likely to provide a reasonable basis for conclusions about the population. These conclusions are subject to the limitations of sampling risk.

Basic precision (424) In monetary unit sampling, the reliability factor (for zero misstatements at the planned risk of incorrect acceptance) times the sampling interval. (Module 9A)

Confidence interval (434) An interval constructed by using the estimated total audited value $\pm$ the allowance for sampling risk. When the population book value is within this interval, the population is accepted as being materially accurate at the planned sampling risks. This is also referred to as the acceptance interval. (Module 9B)

Confidence level (400) The complement of the risk of incorrect acceptance. The measure of probability associated with a sample interval. Also referred to as reliability.

Control risk (450) The risk that a material misstatement could occur in a financial statement assertion and not be prevented, or detected and corrected, on a timely basis by internal control.

Detection risk (450) The risk that the auditors' procedures will lead them to conclude that a financial statement assertion is not materially misstated when in fact such misstatement does exist.

Deviation rate (399) A defined rate of departure from prescribed controls. Also referred to as *occurrence rate* or *exception rate*.

Difference estimation (398) A sampling plan that uses the difference between the audited (correct) values and book values of items in a sample to calculate the estimated total audited value of the population. Difference estimation is used in lieu of ratio estimation when the differences are not nearly proportional to book values. (Module 9B)

Discovery sampling (397) A sampling plan for locating at least one deviation, providing that the deviation occurs in the population with a specified frequency.

Dollar-unit sampling (397) See *monetary unit sampling*.

Dual-purpose procedure (test) (398, 412) An audit procedure that serves as a test of controls and a substantive test of the details of the transactions that occurred during the period. For example, a test of controls over equipment acquisitions may address authorization (providing evidence on control effectiveness) and whether the transaction tested has been properly recorded in the year's acquisitions (providing substantive evidence on the dollar amounts). As another example, a substantive procedure may reveal a misstatement and be extended to determine the nature of the control that did not operate effectively, thereby providing evidence on operating effectiveness.

Estimated total audited value (433) In variables sampling, the most likely audited total in the population based on the extrapolation of the sample results. For example, in mean-per-unit sampling, this is equal to the mean sample audited value multiplied by the number of items in the population. See also *point estimate (of audited value)*. (Module 9B)

Expected population deviation rate (399) An advance estimate of a deviation rate. This estimate is necessary for determining the required sample size in an attributes sampling plan.

Incremental allowance (424) In monetary unit sampling, an amount determined by ranking the misstatements for logical units that are less than the sampling interval and considering incremental changes in reliability factors. (Module 9A)

Individually significant items (397) A term used in the AICPA *Audit Sampling Guide* that includes items in a population that individually represent a relatively high risk of misstatement due to their size (generally each is larger than the tolerable misstatement) or due to their risk of misstatement due to error or fraud. (Module 9B)

Inherent risk (450) The risk of a material misstatement of a financial statement assertion before considering any related controls. Inherent risk may increase due to qualitative and quantitative inherent risk factors.

Mean (432) The average item value, computed by dividing total value by the number of items composing total value.

Mean-per-unit estimation (398) A classical variables sampling plan enabling the auditors to estimate the average dollar value (or other variable) of items in a population by determining the average value of items in a sample. (Module 9B)

Monetary unit sampling (MUS) (397, 422) A form of variables sampling in which each dollar in a population is a separate sampling unit for sample selection purposes. For example, a population with a total of \$10,000 is viewed as containing 40,000 sampling units. It sometimes is referred to as dollar-unit sampling or probability-proportional-to-size sampling. (Module 9A)

Nonsampling risk (393) The risk that auditors reach an erroneous conclusion for a reason not related to sampling risk. This risk normally relates to "human" rather than "statistical" errors.

Physical representation of the population (394) The population from which the auditors sample. The physical representation of the population differs from the actual population when it does not include items that exist in the actual population (e.g., the auditors sample from a trial balance of receivables that may or may not include all actual receivables).

Point estimate (of the audited value) (398) The most likely rate or amount in the population based on the extrapolation of the sample results. With attributes sampling this will ordinarily be a percentage, while with variables sampling it will be an amount. For example, for attributes sampling, the point estimate of the deviation rate from a particular control in the population may be 2 percent based on sample results; for variables sampling, the point estimate of accounts receivable may be, for example, \$6,100,000. The point estimate is also referred to as the auditor's best estimate of the deviation rate (attributes sampling) or the population estimated total audited value (variables sampling).

Population (393) The entire field of items from which a sample might be drawn.

Precision (399) See *allowance for sampling risk*.

Projected misstatement (394) The auditor's best estimate of misstatement in populations, involving the projection of misstatements identified in audit samples to the entire population from which the samples were drawn. The projected misstatement is also referred to as likely misstatement or most likely misstatement. In monetary unit sampling, it is calculated by combining two amounts: (1) for accounts less than the size of the sampling interval, the sum of the percentage misstatement (tainting) times the sampling interval for each misstated account, and (2) for accounts equal to or greater than the size of the sampling interval, the sum of the actual misstatement for each misstated account.

Random selection (394) Selecting items from a population in a manner in which every item has an equal chance of being included in the sample.

Ratio estimation (398) A sampling plan that uses the ratio of audited (correct) values to book values of items in the sample to calculate the estimated total audited value of the population. Ratio estimation is used in lieu of difference estimation when the differences are nearly proportional to book values. (Module 9B)

Reliability (446) The complement of the risk of incorrect acceptance. Also referred to as the confidence level.

Representative sample (393) A sample possessing essentially the same characteristics as the population from which it was drawn.

Risk of assessing control risk too high (400) This risk is the possibility that the assessed level of control risk based on the sample is greater than the true operating effectiveness of the control.

Risk of assessing control risk too low (400) This most important risk is the possibility that the assessed level of control risk based on the sample is less than the true control risk based on the operating effectiveness of the controls.

Risk of incorrect acceptance (432) The risk that sample results will indicate that a population is not materially misstated when, in fact, it is materially misstated.

Risk of incorrect rejection (432) The risk that sample results will indicate that a population is materially misstated when, in fact, it is not.

Risk of material misstatement (405, 450) The risks that the financial statements are misstated. A risk of material misstatement exists when (a) there is a reasonable possibility of a misstatement occurring (that is, its likelihood) and (b) if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude). The risks of material misstatement are addressed by auditors at the *financial statement level* and at the *assertion level*. At the *financial statement level*, it relates to risks that relate pervasively to the financial statement as a whole and potentially may affect many assertions. At the *assertion level*, it relates to specific assertions and consists of two components: inherent risk and control risk.

Sampling error (398) The difference between the actual rate or amount in the population and that of the sample. For example, if an actual (but unknown) deviation rate of 3 percent exists in the population, and the sample's deviation rate is 2 percent, the sampling error is 1 percent.

Sampling risk (393) The risk that the auditors' conclusion based on a sample might be different from the conclusion they would reach if the test were applied to the entire population. For tests of controls, sampling risks include the risks of assessing control risk too high and too low; for substantive testing, sampling risks include the risks of incorrect acceptance and rejection.

Sampling unit (394, 407) The individual items constituting a population. For example, in attributes sampling, this may be authorization for individual cash disbursements during the period being audited. In classical variables sampling, for accounts receivable, it may be either individual accounts receivable at year-end by customer or individual sales collectible as of year-end.

Sequential (stop-or-go) sampling (410) A sampling plan in which the sample is selected in stages, with the need for each subsequent stage being conditional on the results of the previous stage.

Standard deviation (399) A measure of the variability or dispersion of item values within a population; in a normal distribution, 68.3 percent of all item values fall within ± 1 standard deviation of the mean, 95.4 percent fall within ± 2 standard deviations, and 99.7 percent fall within ± 3 standard deviations. One method of calculating the standard deviation involves subtracting the value of each item in a population (or sample) from the mean overall item value in the population (or sample). Each item's deviation from the mean is squared, and an average individual squared deviations is calculated. The resulting value is known as the variance. Standard deviation is the square root of the variance.

Stratification (397) Dividing a population into two or more subgroups (strata), each of which is a group of sampling units that have similar characteristics. Stratification increases the efficiency of most sampling plans by reducing the variability of items in each stratum. Stratification may be used to focus audit procedures on risk areas or to reduce the variability in sampling populations (which may decrease the total required sample size).

Systematic selection (396) The technique of selecting a sample by drawing every n th item in the population, following one or more random starting points.

Tainting (424) In monetary unit sampling, the percentage of misstatement of an item (misstatement amount divided by book value). (Module 9A)

Tolerable deviation rate (400) The maximum population rate of deviations from a prescribed control that the auditor will tolerate without modifying the planned assessment of control risk.

Tolerable misstatement (398) An estimate of materiality for the particular audit test.

Upper limit on misstatement (424) In monetary unit sampling, the sum of projected misstatement, basic precision, and the incremental allowance. This total is used to evaluate sample results. (Module 9A)

Variables sampling (432) Sampling methods that reach a conclusion on amounts (generally monetary) of a population. It includes monetary unit sampling, classical variables sampling, and nonstatistical variables sampling.

Voucher (396) A document authorizing a cash disbursement. A voucher usually provides space for the initials of employees performing various approval functions. The term *voucher* may also be applied to the group of supporting documents used as a basis for recording liabilities or for making cash disbursements.

Review Questions

- 9-1. Define, and differentiate between, nonstatistical (judgmental) sampling and statistical sampling.
- 9-2. Describe the difference between sampling risk and nonsampling risk.
- 9-3. Explain what is meant by the following statement: "When sampling, the auditors should determine that the physical representation of the actual population is complete."
- 9-4. In selecting items for examination, an auditor considered three alternatives: (a) random number table selection, (b) systematic selection, and (c) random number generator selection. Which, if any, of these methods would lead to a random sample if properly applied?
- 9-5. Explain briefly the term *systematic selection* as used in auditing and indicate the precautions to be taken if a random sample is to be obtained. Is systematic selection applicable to unnumbered documents? Explain.
- 9-6. Explain the meaning of sampling without replacement and sampling with replacement.
- 9-7. Which technique results in a smaller sample size, sampling with or without replacement?
- 9-8. An auditor is sampling with replacement and, by chance, a particular account has been selected twice. Should it be included two times in the sample?
- 9-9. What are the three major factors that determine the sample size for an attributes sampling plan?
- 9-10. When using attributes sampling, the auditors must estimate the expected population deviation rate. What sources are used to make this estimate?
- 9-11. When performing attributes sampling, may auditors include several types of attributes in their definition of a deviation? Explain.
- 9-12. What effects will an auditor's belief that the population's actual deviation rate exceeds the tolerable deviation rate have on the test of controls sample size?
- 9-13. What is a dual-purpose test?
- 9-14. When performing a dual-purpose test, how does the auditor arrive at the required sample size?
- 9-15. If a sample of 100 items indicates a deviation rate of 3 percent, should the auditors conclude that the entire population also has approximately a 3 percent deviation rate?
- 9-16. What relationship exists between the expected population deviation rate and sample size when using attribute sampling?
- 9-17. What would be the difference between an attributes sampling plan and a variables sampling plan in a test of inventory extensions?
- 9-18. Describe what is meant by a sequential sampling plan.
- 9-19. In performing a substantive test of the book value of a population, auditors must be concerned with two aspects of sampling risk. What are these two aspects of sampling risk, and which aspect is of greater importance to auditors? Explain.
- 9-20. CPAs may decide to apply nonstatistical or statistical techniques to audit testing.
 - a. List and explain the advantages of applying statistical sampling techniques to audit testing.
 - b. List and discuss the decisions involving professional judgment that must be made by the CPAs in applying statistical sampling techniques to tests of controls.
 - c. You have applied attributes sampling to the client's pricing of the inventory and discovered from your sampling that the sample deviation rate exceeds your tolerable rate. Discuss the courses of action you take.

Questions LO 9-2, 6 Requiring Analysis



- LO 9-6** 9–21. In performing a test of controls for sales order approvals, the CPAs stipulate a tolerable deviation rate of 8 percent with a risk of assessing control risk too low of 5 percent. They anticipate a deviation rate of 2 percent.
- What type of sampling plan should the auditors use for this test?
 - Using the appropriate table or formula from this chapter, compute the required sample size for the test.
 - Assume that the sample indicates four deviations. May the CPAs conclude with a 5 percent risk of assessing control risk too low that the population deviation rate does not exceed the tolerable rate of 8 percent?

This problem includes additional parts that require the use of generalized audit software. See the Connect Instructor Library or Connect's Additional Student Resources for more information.

- LO 9-6** 9–22. An auditor has reason to suspect that fraud has occurred through forgery of the treasurer's signature on company checks. The population under consideration consists of 3,000 checks. Can discovery sampling rule out the possibility that any forged checks exist?

Objective Questions

- LO 9-1** 9–23. **Multiple Choice Questions**
Select the best answer for each of the following questions. Explain the reasons for your selection.
- Which of the following is an element of sampling risk?
 - Choosing an audit procedure that is inconsistent with the audit objective.
 - Concluding that no material misstatement exists in a materially misstated population based on taking a sample that includes no misstatement.
 - Failing to detect an error on a document that has been inspected by an auditor.
 - Failing to perform audit procedures that are required by the sampling plan.
 - In assessing sampling risk, the risk of incorrect rejection and the risk of assessing control risk too high relate to the:
 - Efficiency of the audit.
 - Effectiveness of the audit.
 - Selection of the sample.
 - Audit quality controls.
 - Which of the following statistical sampling techniques is least desirable for use by the auditors?
 - Random number table selection.
 - Block selection.
 - Systematic selection.
 - Random number generator selection.
 - The auditors' primary objective in selecting a sample of items from an audit population is to obtain:
 - A random sample.
 - A stratified sample.
 - A representative sample.
 - A large sample.
 - Discovery sampling is particularly effective when:
 - There are a large number of errors in the population.
 - The auditors are looking for critical deviations that are not expected to be frequent in number.
 - The auditors know where deviations are likely to occur.
 - The population is large in size.
 - Sampling that reaches a conclusion about a population in terms of a rate of occurrence is:
 - Attributes sampling.
 - Binomial sampling.
 - Occurrence sampling.
 - Variables sampling.

LO 9-4, 6

- g. What effect on sample size does increasing the allowable risk of incorrect acceptance have for a substantive test?
- (1) Decrease.
 - (2) Increase.
 - (3) Indeterminate.
 - (4) No effect.

LO 9-5

- h. Which of the following is accurate regarding tolerable misstatement?
- (1) Tolerable misstatement is directly related to materiality.
 - (2) Tolerable misstatement cannot be determined until the sample results are evaluated.
 - (3) Tolerable misstatement does not affect sample size.
 - (4) Tolerable misstatement is a measure of reliability of the sample.

LO 9-6

- i. In which of the following circumstances is it least likely that tests of controls will be performed?
- (1) The expected deviation rate exceeds the tolerable deviation rate.
 - (2) The planned assessed level of control risk is at a level slightly below the maximum.
 - (3) The risk of assessing control risk too low is less than the expected deviation rate.
 - (4) The tolerable deviation rate exceeds the risk of assessing control risk too low.

LO 9-6

- j. In attributes sampling, what effect does a decrease in the tolerable deviation rate have on sample size?
- (1) Decrease.
 - (2) Increase.
 - (3) Indeterminate.
 - (4) No effect.

LO 9-6

- k. In attributes sampling, what effect does an increase in the acceptable risk of assessing control risk too low have on sample size?
- (1) Decrease.
 - (2) Increase.
 - (3) Indeterminate.
 - (4) No effect.

LO 9-6

- l. This year the audit plan, as compared to the prior year, includes a lower risk of assessing control risk too low. Other factors held constant, which of the following is most likely to be correct relating to the planned risk of incorrect acceptance for substantive procedures?
- (1) Lower than prior year.
 - (2) Same as prior year.
 - (3) Higher than prior year.
 - (4) Indeterminate as there is no certain relationship between the acceptable levels of the risks.

LO 9-6

- 9–24. You have been asked to test the effectiveness of Ingo Corporation's control of manually approving all purchases over \$25,000. During the year, Ingo Corporation has made 1,000,000 purchases, of which 3,000 were over \$25,000. Jian Zhang, CPA, your supervisor, asked you to use a tolerable deviation rate of 4 percent (although she expects the rate to be only approximately 0.25 percent) and a 5 percent risk of assessing control risk too low. Use the following to determine the planned assessed level of control risk and the assessed level of control risk.

(Planned) Assessed Level of Control Risk	Tolerable Deviation Rate
Low	2–7%
Moderate	6–12%
Slightly below the maximum	11–20%
Maximum	Over 20%

For all parts of this question, select the proper reply from below.

- What is the planned assessed level of control risk?
- Determine the appropriate sample size and allowable number of deviations using Figure 9.4.

For parts c1 through c6 assume that the sample size was 100 items. Use Figure 9.5 to determine the achieved upper deviation rate and the above table to determine the assessed level of control risk under the following circumstances.

Circumstance	Achieved Upper Deviation Rate	Assessed Level of Control Risk
No deviations were included in the sample.	c1	c4
One deviation is included in the sample.	c2	c5
Eight deviations were included in the sample.	c3	c6

Replies		
Planned and Assessed Level of Control Risk (Questions a, c4, c5, c6)	Sample Size (Question b)	Achieved upper Deviation Rate (Questions c1, c2, c3)
1. Low	5. 74 items	10. 0.00%
2. Moderate	6. 93 items	11. 2.00%
3. Slightly below the maximum.	7. 117 items	12. 2.52%
4. Maximum.	8. 119 items	13. 3.00%
	9. 236 items	14. 3.99%
		15. 4.70%
		16. 6.20%
		17. 12.13%
		18. 14.00%
		19. 18.00%

- LO 9-5** 9–25. The professional development department of a large CPA firm has prepared the following illustration to familiarize the audit staff with the relationships of sample size to population size and variability and the auditors' specifications in regard to the tolerable misstatement and the risk of incorrect acceptance.

			Auditors' Specifications as to a Sample from Population 1 Relative to a Sample from Population 2	
			Tolerable Misstatement	Planned Risk of Incorrect Acceptance
Characteristics of Population 1 Relative to Population 2				
	Size	Variability		
Case 1	Larger	Equal	Equal	Equal
Case 2	Equal	Larger	Larger	Equal
Case 3	Larger	Equal	Smaller	Equal
Case 4	Smaller	Smaller	Equal	Lower
Case 5	Smaller	Equal	Larger	Higher

For each of the five cases in the preceding illustration, indicate the relationship of the sample size to be selected from population 1 relative to the sample from population 2. Select your answer from the following numbered responses and state the reasoning behind your choice. The required sample size from population 1 is:

- Larger than the required sample size from population 2.
- Equal to the required sample size from population 2.
- Smaller than the required sample size from population 2.
- Indeterminate relative to the required sample size from population 2.

Problems LO 9-6

- 9-26. The use of statistical sampling techniques in an audit of financial statements does not eliminate judgmental decisions.
- Identify and explain four areas in which judgment may be exercised by CPAs in planning a statistical test of controls.
 - Assume that the auditors' sample shows an unacceptable deviation rate. Discuss the various actions that they may take based upon this finding.
 - A nonstratified sample of 80 accounts payable vouchers is to be selected from a population of 3,200. The vouchers are numbered consecutively from 1 to 3,200 and are listed, 40 to a page, in the voucher register. Describe four different techniques for selecting a random sample of vouchers for inspection.
(AICPA, adapted)
- LO 9-6 9-27. As part of your audit of the Gamma Company accounts payable function, your audit plan includes a test of controls addressing the company policy requiring that all vouchers be properly approved. You estimate the population deviation rate to be 3 percent.
- In addition to an estimate of population deviation rate, what factors affect the size of the sample needed?
 - What bases could be used to provide an estimate of the population deviation rate?
 - Assume that a sample of 100 has been drawn, audit tests performed, and a sample deviation rate of 4 percent computed. Furthermore, you have selected a 5 percent risk of assessing control risk too low as appropriate. Use the appropriate table to determine the achieved upper deviation rate.
 - What actions can be taken to deal with a situation in which the achieved upper deviation rate exceeds the tolerable rate?

This problem includes additional parts that require the use of generalized audit software. See the Connect Instructor Library or Connect's Additional Student Resources for more information.

In-Class Team Case LO 9-6

- 9-28. Kevin Koy, CPA, was engaged to audit Tolle Company's financial statements for the year ended December 31, 20X0. After obtaining an understanding of Tolle's internal control, Koy decided to obtain audit evidence about the effectiveness of both the design and operation of the controls that may support a low assessed level of control risk concerning Tolle's shipping and billing functions. During the prior years' audits, Koy had used nonstatistical sampling, but for the current year Koy decided to use a statistical sample in the tests of controls to eliminate the need for judgment.

Koy wanted to assess control risk at a low level, so a tolerable rate of deviation of 20 percent was established. To estimate the population deviation rate and the achieved upper deviation rate, Koy decided to apply the discovery sampling method with an expected population deviation rate of 3 percent for the 8,000 shipping documents, and he decided to defer consideration of the risk of assessing control risk too low until the sample results had been evaluated. Koy used the tolerable rate, the population size, and the expected population deviation rate to determine that a sample size of 80 would be sufficient. When it was subsequently determined that the actual population was about 10,000 shipping documents, Koy increased the sample size to 100.

Koy's objective was to ascertain whether Tolle's shipments had been properly billed. Koy took a sample of 100 invoices by selecting the first 25 invoices from the first month of each quarter. Koy then compared the invoices to the corresponding prenumbered shipping documents.

When Koy tested the sample, 8 deviations were discovered. Additionally, one shipment that should have been billed at \$10,443 was actually billed at \$10,434. Koy considered this \$9 to be immaterial and did not count it as a deviation.

In evaluating the sample results, Koy made the initial determination that a reliability level of 95 percent (risk of assessing control risk too low of 5 percent) was desired and, using the appropriate statistical sampling table, determined that for 8 observed deviations from a sample size of 100, the achieved upper deviation rate was 14 percent. Koy then calculated the allowance for sampling risk (5 percent), the difference between the actual sample deviation rate (8 percent), and the expected deviation rate (3 percent). Koy reasoned that the actual sample

deviation rate (8 percent) plus the allowance for sampling risk (5 percent) was less than the achieved upper deviation rate (14 percent); therefore, the sample supported a low level of control risk.

Describe each incorrect assumption, statement, and inappropriate application of attributes sampling in Koy's procedures.

(AICPA, adapted)

Module 9A

Monetary Unit Sampling (MUS)

LO 9-7

Plan, perform, and evaluate samples for substantive procedures using monetary unit sampling. (Module 9A)

Monetary unit sampling (MUS)⁶ is a technique for variables sampling that views a population as being composed of individual dollars (or other type of monetary unit amount) in its sample selection. It is popular because of its ease of use and because it often results in smaller samples than classical variables sampling approaches. Also, it is readily available on software packages such as IDEA and ACL.

Whereas classical variables sampling plans define the population as a group of accounts or transactions, MUS defines the population as the individual dollars comprising the population's book value. Thus, a population of 5,000 accounts receivable with a total dollar value of \$2,875,000 is viewed as a population of 2,875,000 sample units (dollars), rather than 5,000 sampling units (accounts).

Determination of Sample Size

The factors affecting sample size in MUS are (1) the population book value, (2) the tolerable misstatement, (3) the expected misstatement in the population, and (4) the risk of incorrect acceptance (incorporated through the reliability and expansion factors). Specifically, the sample size for MUS may be computed⁷ as follows:

$$\text{Sample size} = \frac{\text{Population book value} \times \text{Reliability factor}}{\text{Tolerable misstatement} - (\text{Expected misstatement} \times \text{Expansion factor})}$$

Several of the factors in the MUS formula need very little additional explanation. The population book value is the recorded amount of the population being audited. The tolerable misstatement is the maximum monetary misstatement that may exist in the population without causing the financial statements to be materially misstated. The expected misstatement is the auditors' estimate of the dollar amount of misstatement in the population. The auditors estimate the expected misstatement using professional judgment based on prior experience and knowledge of the client. The other factors used to calculate sample size are based on the auditors' desired risk of incorrect acceptance and are obtained from tables, such as the one in Figure 9.10. The "zero misstatements" row of Figure 9.10 is always used for obtaining the reliability factor for determining sample size. Thus, if a 10 percent risk of incorrect acceptance is desired, the auditors use a reliability factor of 2.31. The expansion factor comes directly from Figure 9.11. For a 10 percent risk of incorrect acceptance, the factor is 1.5.

Controlling Sampling Risk

The auditors decide on an appropriate level of risk of incorrect acceptance based on the extent of the evidence required from the sample. This level of risk is then used to obtain

⁶ Variations of this sampling technique are referred to as **dollar-unit sampling** and **probability-proportional-to-size sampling**.

⁷ This formula is included in the AICPA *Audit Sampling Guide* as one way to obtain a sample size. The *Guide* also includes tabular approaches.

FIGURE 9.10 Reliability Factors for Misstatements of Overstatement

Number of Overstatement Misstatements	Risk of Incorrect Acceptance								
	1%	5%	10%	15%	20%	25%	30%	37%	50%
0*	4.61	3.00	2.31	1.90	1.61	1.39	1.21	1.00	0.70
1	6.64	4.75	3.89	3.38	3.00	2.70	2.44	2.14	1.68
2	8.41	6.30	5.33	4.72	4.28	3.93	3.62	3.25	2.68
3	10.05	7.76	6.69	6.02	5.52	5.11	4.77	4.34	3.68
4	11.61	9.16	8.00	7.27	6.73	6.28	5.90	5.43	4.68
5	13.11	10.52	9.28	8.50	7.91	7.43	7.01	6.49	5.68
6	14.57	11.85	10.54	9.71	9.08	8.56	8.12	7.56	6.67
7	16.00	13.15	11.78	10.90	10.24	9.69	9.21	8.63	7.67
8	17.41	14.44	13.00	12.08	11.38	10.81	10.31	9.68	8.67
9	18.79	15.71	14.21	13.25	12.52	11.92	11.39	10.74	9.67
10	20.15	16.97	15.41	14.42	13.66	13.02	12.47	11.79	10.67

* The 0 row is always used for the reliability factor in the sample size formula and for basic precision.

Source: AICPA, *Audit Guide: Audit Sampling* (New York, 2017).

FIGURE 9.11
Expansion Factors for
Expected Misstatement

	Risk of Incorrect Acceptance								
	1%	5%	10%	15%	20%	25%	30%	37%	50%
Factor	1.9	1.6	1.5	1.4	1.3	1.25	1.2	1.15	1.0

Source: AICPA, *Audit Guide: Audit Sampling* (New York, 2017).

the appropriate factors to calculate sample size. The risk of incorrect rejection is indirectly controlled by the auditors' estimate of expected misstatement that is used to calculate the MUS sample size. To reduce the risk of incorrect rejection, the auditors increase their estimate of expected misstatement. If the auditors underestimate the expected misstatement, the sample size will not be large enough and additional testing may be necessary in order to accept the account balance as being materially correct.

Method of Sample Selection

Auditors generally use a *systematic selection* approach when using MUS. However, because the sampling unit is based on dollars, not individual accounts, the sampling interval is also based on dollars. The sampling interval is calculated as follows:

$$\text{Sample interval} = \frac{\text{Population book value}}{\text{Sample size}}$$

To illustrate, assume that the auditors are sampling 200 items from a population of accounts receivable totaling \$300,000; the sampling interval is calculated to be \$1,500 (\$300,000 ÷ 200). A random starting point is selected between \$1 and \$1,500, say, \$412. The account with the 412th dollar will be the first sample item. Then, the sample will include the accounts receivable that contain every \$1,500 from the starting point, as illustrated in Figure 9.12. The accounts included in Figure 9.12 are considered "logical units" because when applying MUS, the auditors generally cannot audit only the dollar selected but must audit the entire account, invoice, or voucher. Consider the confirmation of accounts receivable. Sending a confirmation of a specific dollar in a selected balance is not generally feasible; the auditors must confirm the entire account balance or transaction from the account balance. Also note that, in using a systematic sampling plan, every account with a book value as large as or larger than the sampling interval will be included in the sample. In our example, because every 1,500th dollar is being selected in Figure 9.12, account 0003 for \$1,700 will always be included.

FIGURE 9.12
MUS Selection Process

Account Number	Book Value	Cumulative Total	Dollar Selected	Sample Item Book Value
0001	\$1,000	\$ 1,000	\$ 412	\$1,000
0002	42	1,042		
0003	1,700	2,742	1,912	1,700
0004	666	3,408		
0005	50	3,458	3,412	50
.	.	.	.	.
.	.	.	.	.
.	.	.	.	.
4217	17	300,000		

Evaluation of Sample Results

After the sample has been selected and procedures applied to arrive at audited values for the individual accounts, the MUS sample is evaluated. The MUS evaluation procedure involves calculating an **upper limit on misstatement**, which is an estimate of the maximum amount of misstatement in the account. The upper limit on misstatement has two already familiar components—the *projected misstatement* and the *allowance for sampling risk*. However, in MUS sampling, the allowance for sampling risk is made up of two other components, the **basic precision** and the **incremental allowance**. Mathematically, these relationships may be described as follows:

$$\begin{array}{lcl} \text{Upper limit} & = & \text{Projected} \\ \text{on misstatement} & & \text{misstatement} + \text{Allowance for} \\ & & \text{and} \quad \text{sampling risk,} \\ \text{Allowance for} & = & \text{Basic} \\ \text{sampling risk} & & \text{precision} + \text{Incremental} \\ & & \text{allowance} \end{array}$$

Therefore:

$$\text{Upper limit on misstatement} = \text{Projected misstatement} + \text{Basic precision} + \text{Incremental allowance}$$

As is the case with the classical sampling approaches, the projected misstatement may be viewed as the auditors' "best estimate" of the most likely misstatement in the population. The projected misstatement in the population is determined by summing the projected misstatement for each account, or other logical unit, in the sample. Thus, when the sample includes no misstatements, the projected misstatement is zero. If misstatements do exist in the sample, the method used to project the misstatements in a particular account depends on whether the book value of the account found to be in error is less than the sampling interval. For accounts with book values that are less than the amount of the sampling interval, the projected misstatement is calculated by multiplying the percentage of misstatement in the account, known as the **tainting**, times the sampling interval. Thus, if an account with a book value of \$100 is found to have an audited value of \$60, the misstatement in the account is \$40 (\$100 – \$60) and the tainting is 40 percent (\$40 ÷ \$100). The tainting of 40 percent would then be multiplied by the sampling interval to get the projected misstatement for that account. Accounts with balances less than the sampling interval are used to represent other unselected items in that interval. Thus, for accounts with book values that are less than the sampling interval, *the account's tainting percentage is projected to the entire interval from which it was selected*.

For accounts with book values equal to or greater than the sampling interval, *the actual misstatement in the account is used as the projected misstatement*. The reason for the difference in the methods of calculation of the projected misstatement is that every account with a book value equal to or greater than the sampling interval will be included in the sample. These items do not represent other unselected items in that sampling interval; therefore, the actual misstatement in the account is equal to the projected misstatement.

The next step in determining the upper limit on misstatements involves calculating the two components of the allowance for sampling risk—the basic precision and the incremental allowance. The basic precision is always found by multiplying the reliability factor for zero misstatements from Figure 9.10 by the sampling interval.

When misstatements are discovered in the sample, the incremental allowance is found by (1) ranking the projected misstatements for the accounts with book values less than the sampling interval from largest projected misstatement to smallest projected misstatement, (2) multiplying each projected misstatement by an incremental factor calculated from the reliability factors in Figure 9.10, and (3) summing the resulting amounts. When no misstatements of accounts with book values less than the sampling interval are found in the sample, the incremental allowance is zero.

To complete the quantitative evaluation of the sample results, the auditors compute the upper limit on misstatements. When misstatements are found, the upper limit is computed by adding together the projected misstatement, the basic precision, and the incremental allowance. Of course, if no misstatements are found in the sample, the upper limit on misstatements consists only of the basic precision.

After the upper limit on misstatements is calculated, the auditors compare it to the tolerable misstatement for the account. If the upper limit on misstatements is less than or equal to tolerable misstatement, the sample results support the conclusion that the population is not misstated by more than tolerable misstatement at the specified level of sampling risk. On the other hand, if the upper limit on misstatements exceeds the amount of tolerable misstatement, the sample results do not provide the auditors with enough assurance that the misstatement in the population is less than the tolerable misstatement.

Illustration of MUS

We structure our illustration around the steps for substantive tests of details as presented in Chapter 9.

1. *Determine the objective of the substantive test of details.* Assume that the auditors wish to send customers confirmation requests to test the existence and gross valuation of recorded accounts receivable of ABC Company, a company that sells inexpensive Internet-related products.
2. *Define the population and sampling unit.* While most of ABC Company's sales are to customers who use credit cards or services such as PayPal, a number of customers are on an approved customer list and are granted credit. Receivables from these customers make up the population of accounts receivable on ABC Company's financial statements. At year-end, this population includes 100,000 uncollected sales invoices from 53,000 customers, recorded at a total book value of \$6,250,000. Based on a belief that it will be easier for customers to confirm individual unpaid purchases rather than their month-end balance due, the auditors decide to confirm a sample of uncollected sales invoices through direct correspondence with the customers rather than confirming account balances. Therefore, each uncollected sales invoice per the accounting records at year-end represents a sampling unit. Figure 9.13 summarizes the sampling units, uncollected sales invoices.
3. *Choose an audit sampling technique.* The auditors have decided to use the monetary unit sampling technique applied with systematic selection.
4. *Determine the sample size.* To calculate the required sample size, the auditors must determine (a) the population book value, (b) the tolerable misstatement for the test, (c) the expected misstatement, and (d) the planned level of the risk of incorrect acceptance.

Based on their consideration of internal control, the auditors believe that all uncollected sales invoices are included in the client's 100,000 uncollected sales invoices (the physical representation of the population). Because internal control over existence and valuation of accounts receivable is very weak, the auditors assess control risk at the maximum level, that is, 100 percent. In addition, they assess inherent risk at

FIGURE 9.13
Uncollected Sales
Invoices

ABC COMPANY Population of Uncollected Sales Invoices December 31, 20X3			
Population Item Number	Sales Invoice Number	Account Name	Book Value
1	145617	Bill Jones	\$ 41.58
2	123452	Barrett Slary	69.50
3	142944	Sarah Smoker	44.46
4	124585	Bill Ga	49.31
5	145213	Jane Zhang	63.57
:	:	:	:
:	:	:	:
:	:	:	:
99,999	132027	Barrett Gingin	82.25
100,000	154923	Ringo Starling	99.20
Total book value			\$6,250,000.00
Mean account value			\$ 62.50

100 percent. Also they plan to perform only very limited additional substantive procedures other than this procedure on these assertions. Therefore, the auditors decide on a 5 percent risk of incorrect acceptance. Based on the auditors' consideration of performance materiality for accounts receivable, they specify tolerable misstatement at \$364,000. Previous audit results lead them to expect an overstatement of approximately \$50,000.

Because the auditors are using a risk of incorrect acceptance of 5 percent, the reliability factor from Figure 9.10 is 3.00, and the expansion factor from Figure 9.11 is 1.6. Remember that for calculating sample size, the zero misstatement row of Figure 9.10 is always used. Using this information, the sample size and sampling interval may be calculated as follows:

$$\begin{aligned}
 \text{Sample size} &= \frac{\text{Population book value} \times \text{Reliability factor}}{\text{Tolerable misstatement} - (\text{Expected misstatement} \times \text{Expansion factor})} \\
 &= \frac{\$6,250,000 \times 3.00}{\$364,000 - (\$50,000 \times 1.6)} = 66 \\
 \text{Sampling interval} &= \frac{\text{Population book value}}{\text{Sample size}} \\
 &= \frac{\$6,250,000}{66} = \$95,000 \text{ (approximately)}
 \end{aligned}$$

5. *Select the sample.* Using the MUS systematic selection method (after a random start within the first interval), the auditors select the dollars and then the uncollected sales invoices to be included in the sample.
6. *Test the sample items.* The auditors send the confirmation requests and perform additional procedures as appropriate. They identify three misstatements:

Book Value	Audited Value
\$ 100	\$ 90
2,000	1,900
102,000	102

7. *Evaluate the sample results.* Based on the above misstatements, the projected misstatement, basic precision, and the incremental allowance are calculated in Figure 9.14.

The calculation of projected misstatement is straightforward, and no table values are required. Note that the tainting percentages for the first two misstatements are computed by dividing the misstatement amount by the book value of the account. Then, the tainting percentages are multiplied by the sampling interval to calculate the

FIGURE 9.14 MUS Illustration of Calculation of Upper Limit on Misstatement

Projected Misstatement:						
Book Value	Audited Value	Misstatement	Tainting Percentage	Sampling Interval	Projected Misstatement	Upper Limit on Misstatements
\$ 1 00	\$ 90	\$ 10	10%	\$95,000	\$ 9,500	
2,000	1,900	100	5	95,000	4,750	
102,000	102	101,898	NA	NA	101,898	
<u>\$ 104,100</u>	<u>\$ 2,092</u>	<u>\$ 102,008</u>				\$ 116,148
Basic Precision: = Reliability factor × Sampling interval						
= 3.0 × \$95,000 =						\$285,000
Incremental Allowance:						
Reliability Factor	Increment	(Increment – 1)	Projected Misstatement	Incremental Allowance		
3.00		—	—	—		
4.75	1.75	0.75	\$9,500	\$7,125		
6.30	1.55	0.55	4,750	2,613		9,738
Upper Limit on Misstatement:						<u>\$ 410,886</u>

projected misstatement. Because the book value of the account containing the third misstatement is greater than the sampling interval of \$95,000, the projected misstatement for that account is equal to the amount of the misstatement.

The second element of the upper limit on misstatement, basic precision, is simply the reliability factor for zero misstatements and a risk of incorrect acceptance of 5 percent (from Figure 9.10) multiplied by the sampling interval.

The calculation of the incremental allowance uses the projected misstatements of the accounts with book values less than the sampling interval. These projected misstatements are ranked by size from largest projected misstatement to smallest and multiplied by the increment in the reliability factors, reduced by 1. These incremental reliability factors are derived from the factors in Figure 9.10. Because a 5 percent risk of incorrect acceptance was selected and two misstatements were found in accounts with balances less than the sampling interval, the factors of 3.00, 4.75, and 6.30 are taken from Figure 9.10. An incremental factor is calculated as the difference between successive factors. For example, the incremental factor for the first error is 4.75 – 3.00, or 1.75. Then 1 is subtracted from the incremental factor to arrive at the factor that is multiplied by the first projected misstatement, in this case 0.75. This process is repeated for each additional projected misstatement.

Because the upper limit (\$410,886) is in excess of the tolerable misstatement (\$364,000), the auditors would not accept the population as being materially correct. Thus, adjustment of the account, expansion of the test, or audit report modification would be appropriate.⁸ In this situation, the most logical approach would be to persuade the client to adjust for the \$102,008 in actual misstatements found in the sample. This would reduce the upper limit on misstatements to \$308,878 (\$410,886 – \$102,008) and enable the auditors to accept the account as being materially correct.

As with other types of sampling, the auditors should also perform a qualitative evaluation of the results for indications of intentional misstatements or breakdowns in internal control.

8. *Document the sampling procedures.* Each of the prior seven steps, as well as the basis for overall conclusions, should be documented in the auditors' working papers. This documentation should include an identification of the items tested.

⁸ In many circumstances such as this, the client requests that the auditors expand the test either to identify the specific misstatements or to determine that the account is not materially misstated.

Focus on Generalized Audit Software

ACL Services Ltd. is a leading provider of generalized audit software. That software can, among many other things, perform monetary unit sampling. The following is a printout of results using ACL for the problem we have presented in this module:

Confidence: 95%, Interval 95,000			
Item	Error	Most Likely Error	Upper Error Limit
Basic Precision			285,000.00
100.00	10.00	9,500.00	16,625.00
2,000.00	100.00	4,750.00	7,363.00
102,000.00	101,898.00	101,898.00	101,898.00
Totals		116,148.00	410,886.00

Some of the terminology used differs as follows:

ACL	Text
Confidence	1 – Risk of incorrect acceptance
Most likely error	Projected misstatement
Upper error limit	Upper limit on misstatement

Notice that ACL doesn't separately present the incremental allowance. To obtain the "incremental allowance," one may subtract both the basic precision and the most likely error from the total (\$410,886.00 – \$116,148.00 – \$285,000.00 = \$9,738.00).

Considerations in Using Monetary Unit Sampling

Although the formulas for MUS sampling at first seem difficult, once a user becomes familiar with them, they are easier to apply in practice than the classical variables sampling methods. An estimate of the standard deviation of the population need not be made, and the MUS selection method automatically results in an efficient stratification of the sample. The method also provides smaller sample sizes when few misstatements are expected in the sample.

The advantages of MUS sampling do not come without cost. If there are a moderate number of differences between recorded and audited amounts, classical variables sampling methods will result in a smaller sample size. Also, when using MUS, special consideration must be given to (1) accounts with zero balances, (2) accounts with negative balances, and (3) accounts that are understated. CPA firms use various methods to overcome these limitations. Recall that Figure 9.9 in the chapter summarizes advantages and disadvantages of the MUS and classical approaches (presented in Module 9B).

Questions and Problems for Module 9A

Note: All questions and problems emphasize LO 9-7: Plan, perform, and evaluate samples for substantive procedures using monetary unit sampling.

- 9A-1. List the factors affecting sample size in a MUS.
- 9A-2. "When using a systematic sample selection technique with monetary unit sampling, every account larger than the sampling interval will automatically be included in the sample." Do you agree? Explain.
- 9A-3. When using MUS, do auditors select sample items based on individual dollars, audit individual dollars, or both?
- 9A-4. A company has an inventory with a book value of \$4,583,231, which includes 116 product lines and a total of 326,432 units. How many items compose this population for purposes of applying a monetary unit sampling plan? Explain.

- 9A-5. "When no misstatements are found in MUS, the upper limit on misstatement is equal to zero." Is this statement correct? Explain.
- 9A-6. A monetary unit sample with a sampling interval of \$2,000 includes an item with an audited value of \$90. This value was \$30 lower than the account's book value. Calculate the tainting percentage for this account.
- 9A-7. The reliability factor table provides factors for as many as three computations when planning and evaluating the results of a monetary unit sample. Describe in general terms each of these computations.
- 9A-8. In a monetary unit sample with a sampling interval of \$20,000, an auditor discovered that a selected account receivable with a recorded amount of \$10,000 had an audit amount of \$2,000. Calculate the projected misstatement for this one item.
- 9A-9. Len Wagner, CPA, is considering the use of monetary unit sampling in examining the sales transactions and accounts receivable of Mason Wholesale Company.
- How does the definition of the items in an accounts receivable population vary between monetary unit sampling and mean-per-unit sampling?
 - Should a population of accounts receivable be stratified by dollar value before applying monetary unit sampling procedures? Discuss.
- 9A-10. The auditors wish to test the valuation of accounts receivable in the audit of Desert Enterprises of Bullhead City. The client has \$500,000 of total recorded receivables, composed of 850 accounts. The auditors have determined the following:

Tolerable misstatement	\$25,000
Risk of incorrect acceptance	5%
Expected misstatement	\$2,000

The auditors have decided to use monetary unit sampling.

- For planning the sample, calculate:
 - Required sample size.
 - Sampling interval.
- Assume that the auditors have tested the sample and discovered three misstatements:

Book Value	Audited Value
\$ 50	\$ 47
800	760
8,500	8,100

- Projected misstatement.
 - Basic precision.
 - Incremental allowance.
 - Upper limit on misstatement.
- Explain how the auditors would consider the results calculated in requirement (b).

This problem includes additional parts that require the use of generalized audit software. See the Connect Instructor Library or Connect's Additional Student Resources for more information.

Objective Questions

- 9A-11. **Simulation**
- Reply as to whether you believe the following statements are correct (C) or incorrect (I) concerning monetary unit sampling.
- The size of a monetary unit sample is not based on the estimated variation of audited amounts.
 - MUS results in a stratified sample.
 - Individually significant items are automatically identified.
 - MUS results in a smaller sample size when numerous small misstatements are expected.

- e. If few misstatements are expected, MUS will usually result in a smaller sample size than classical variables sampling methods.
- f. One does not need a book value for individual items to evaluate a monetary unit sample.
- g. A MUS eliminates the need to project results to the overall population.
- h. MUS is “preferred” by professional standards.

Use the following information for parts *i* and *j*:

Tolerable misstatement	\$ 50,000
Sample size	100
Expected misstatement	\$ 5,000
Recorded amount of accounts receivable	\$ 300,000

- i. The sampling interval is \$500.
- j. Increasing the expected misstatement to \$10,000 will increase the sample size.

9A-12. Simulation

The following is a computer printout generated by audit software using monetary unit sampling:

WINZ CORPORATION					
Receivable Sampling Evaluation Results					
December 31, 20X2					
Population book value = \$2,400,000; Tolerable misstatement = \$280,000					
Projected Misstatement					
Book Value	Audited Value	Misstatement	Tainting Percentage	Sampling Interval	Projected Misstatement
\$ 1,000.00	\$ 987.50	\$ 12.50	1.25%	\$80,000.00	\$ 1,000.00
750.00	600.00	150.00	20%	\$80,000.00	16,000.00
85,000.00	60,000.00	25,000.00	NA	NA	25,000.00
					\$ 42,000.00
Basic Precision = 3.0 * \$80,000					\$ 240,000.00
Incremental Allowance					
Reliability Factor	Increment	(Increment – 1)	Projected Misstatement	Incremental Allowance	
3.00					
4.75	1.75	.75	\$16,000.00	\$12,000.00	
6.30	1.55	.55	1,000.00	550.00	
				\$12,550.00	

The software uses factors from the following MUS table:

TABLE					
Reliability Factors for Overstatements					
Number of Overstatements	Risk of Incorrect Acceptance				
	1%	5%	10%	15%	20%
0	4.61	3.00	2.31	1.90	1.61
1	6.64	4.75	3.89	3.38	3.00
2	8.41	6.30	5.33	4.72	4.28
3	10.05	7.76	6.69	6.02	5.52
4	11.61	9.16	8.00	7.27	6.73

Answer the following questions relating to the above worksheet:

Questions	Answers
a. What was the planned sample size?	1. 30 items
b. What is the total <i>misstatement</i> in the sample?	2. 60 items
c. What is the most likely total misstatement in the population?	3. 76 items
d. Calculate the upper limit on misstatement.	4. 90 items
e. Calculate the allowance for sampling risk.	5. 0
f. Would one "accept" or "reject" the population as being materially correct?	6. \$ 12,550.00
g. What is the risk of incorrect acceptance?	7. \$ 25,162.50
	8. \$ 42,000.00
	9. \$ 54,550.00
	10. \$ 80,000.00
	11. \$252,550.00
	12. \$280,000.00
	13. \$294,550.00
	14. \$354,550.00
	15. Accept
	16. Reject
	17. 5%
	18. 20%
	19. 100%

In-Class Team Case



- 9A–13. Edwards has decided to use monetary unit sampling (MUS) in the audit of a client's accounts receivable balance. Few, if any, misstatements of the account balance are expected. Edwards plans to use the following MUS table:

Number of Overstatement Misstatements	Risk of Incorrect Acceptance				
	1%	5%	10%	15%	20%
0	4.61	3.00	2.31	1.90	1.61
1	6.64	4.75	3.89	3.38	3.00
2	8.41	6.30	5.33	4.72	4.28
3	10.05	7.76	6.69	6.02	5.52
4	11.61	9.16	8.00	7.27	6.73

- Identify the advantages of using MUS over classical variables sampling.
- Calculate the sampling interval and the sample size Edwards should use given the following information:

Tolerable misstatement	\$ 15,000
Risk of incorrect acceptance	5%
Estimated misstatement	\$ 0
Recorded amount of accounts receivable	\$ 300,000

Note: Requirements (c) through (f) are not related to requirements (a) and (b).

- Assuming a sampling interval of \$5,000, calculate the total projected misstatement if the following three errors were discovered in MUS:

Misstatement	Book Value	Audited Value
1	\$ 400	\$ 320
2	500	0
5	6,000	2,500

- Calculate basic precision and incremental allowance.
- Calculate the upper limit on misstatements.
- Will you accept or reject the account as materially correct? Explain.

This problem includes additional parts that require the use of generalized audit software. See the Connect Instructor Library or Connect's Additional Student Resources for more information. (AICPA, adapted)

Module 9B

Classical Variables Sampling

LO 9-8

Plan, perform, and evaluate samples for substantive procedures using classical variables sampling. (Module 9B)

Classical **variables sampling** plans enable auditors to estimate a numerical quantity, such as the dollar amount of an account balance. This makes these techniques particularly useful for performing substantive procedures. Classical variables sampling methods include *mean-per-unit estimation*, *ratio estimation*, and *difference estimation*. These methods all rely upon the widely known normal distribution theory and its “bell-shaped curve” for analysis.

Prior to sampling, as discussed in the stratification section of this chapter, the auditors will identify individually significant items and audit each of them. Sampling procedures will then be applied to the remainder of the population. To simplify the analysis, our examples assume no individually significant items. However, if such items exist, any uncorrected misstatements identified in those items are added to the projected misstatement.

Mean-Per-Unit

Mean-per-unit estimation enables auditors to estimate the mean audited value of the items in a population, with specified sampling risk and allowance for sampling risk (precision), by determining the mean audited value of the items in a sample. An estimate of the total audited value of the population is obtained by multiplying the sample **mean** (the average audited value of the sample) times the number of items in the population. The *projected misstatement* (the most likely amount of misstatement in the population) may then be calculated as the difference between this estimated total audited value and the client’s book value. The assumption underlying mean-per-unit estimation is that a sample’s mean audited value will, for a certain sampling risk and allowance for sampling risk, represent the true audited mean of the population.

In the following two sections, we provide guidance on how to use mean-per-unit sampling to (1) calculate sample size and (2) evaluate results. We conclude our mean-per-unit discussion with a detailed illustration of the method.

Determination of Sample Size

The following formula may be used to calculate sample size using mean-per-unit sampling:

$$\text{Sample size} = \frac{\left[\frac{\text{Population size (sampling units)} \times \left[\frac{\text{Incorrect acceptance coefficient} + \text{Incorrect rejection coefficient}}{\text{Tolerable misstatement}} \right] \times \text{Estimated standard deviation}}{\text{Tolerable misstatement}} \right]^2}{\text{Tolerable misstatement}}$$

The population size is the number of sampling units in the population. Remember, for accounts receivable, the population size might be either the number of individual account balances or the number of uncollected sales invoices.

In establishing the planned level of the **risk of incorrect acceptance**, the auditors should consider the extent of the evidence that must be obtained from the substantive procedure. This is determined by the auditors’ assessments of inherent risk and control risk for the assertions being tested, and the extent of the evidence obtained from any other substantive tests of those assertions. The Appendix to this chapter describes this process in greater detail.

The **risk of incorrect rejection** is determined by considering the time and other costs involved in performing additional audit procedures when the sample results erroneously indicate that a correct book balance is materially misstated. Some approaches do not control this risk—to do this, one may simply eliminate its factor from the numerator of the sample size formula. For both the risk of incorrect acceptance and the risk of incorrect rejection, risk coefficients from a table such as Figure 9.15, not the risks themselves, are used in the formula. Notice that the risks and coefficients vary inversely—that is, a *decreased* risk is consistent with an *increased* coefficient.

FIGURE 9.15
Risk Coefficients

Acceptable Level of Risk	Incorrect Acceptance Coefficient	Incorrect Rejection Coefficient
1.0%	2.33	2.58
4.6	1.68	2.00
5.0	1.64	1.96
10.0	1.28	1.64
15.0	1.04	1.44
20.0	0.84	1.28
25.0	0.67	1.15
30.0	0.52	1.04
40.0	0.25	0.84
50.0	0.00	0.67

The estimated standard deviation is an estimate of the standard deviation of the population's audited items. This estimate may be obtained in a number of ways, including by calculating the standard deviation of the book values of the population or by using the standard deviation of the audited values of the previous-year audit sample. A less-commonly used method is to obtain an estimate of the standard deviation of the audited values by taking a pilot sample of approximately 50 items. Generalized audit software packages and most spreadsheets include routines designed to calculate the standard deviation of the book values of a population.

The tolerable misstatement, as described in Chapter 6, is the amount considered material for the particular audit procedure. Figure 9.8, presented in Chapter 9, summarizes the effect of the various factors on the required sample size.⁹ However, by simply examining the sample size formula, one may intuitively determine the effects of changing a single factor using the relationships below:

- An increase in any numerator component increases sample size.
- An increase in the denominator (tolerable misstatement) decreases sample size.¹⁰

In determining their overall approach for selecting sampling units, the auditors often use specific knowledge they have about the items in the population being audited. If account values do not vary widely, the auditors may use random selection of items, based on the sample size formula presented in this section. If there are large variations in sizes of items in the population, the auditors will typically choose to select a stratified sample emphasizing sampling units with high values—this will significantly reduce the required sample size. Stratification may be performed using software with stratification formulas that optimize sample sizes, or by simply using their professional judgment.

Evaluation of Sample Results

The sample evaluation process may be viewed as having two stages:

- Calculate the estimated total audited value of the population and the projected misstatement.
- Calculate an allowance for sampling risk and an **acceptance interval** used to arrive at a statistical decision.

Calculate the Estimated Total Audited Value and the Projected Misstatement

The **estimated total audited value** and the projected misstatement are calculated as

Estimated total audited value = Sample mean audited value × Number of items in population

Projected misstatement = Estimated total audited value – Population book value

⁹ When the auditors expect a certain amount of misstatement in the population, perhaps due to the results of previous audits, they may subtract that amount from the tolerable misstatement in the formula. This, in essence, converts the denominator to (tolerable misstatement – expected misstatement).

¹⁰ Be careful with the incorrect acceptance and rejection coefficients. While an increase in either does increase required sample size, it implies a decrease in risk. That is, factor size and risk vary inversely. Stated more simply: A decrease in risk results in a larger sample size.

As indicated in the preceding section, the mean-per-unit method uses the average audited value in the sample to estimate the population total audited value by multiplying it times the number of sample items in the population. The implicit assumption here is that the mean of the audited values in the sample is the best estimate of the mean of the entire audited population.

The projected misstatement is the difference between the estimated total audited value of the population and the population book value. The *projected misstatement represents the best estimate of misstatement in the population* based on the sample results. When the estimated audited value is less than the population book value, the population's book value is estimated to be overstated by the projected misstatement amount; alternatively, when the estimated total audited value is more than the population book value, the book value is estimated to be understated.

While the projected misstatement is the best estimate of misstatement in the population, how does it relate to the tolerable misstatement? When the projected misstatement is greater than the tolerable misstatement, the auditors can readily conclude that the likelihood of the account being materially misstated is much too high. But when the projected misstatement is less than the tolerable misstatement, the auditors are unable to arrive at a definitive conclusion without additional analysis. When using statistical sampling, they may calculate the allowance for sampling risk and the acceptance interval (also referred to as the **confidence interval**).

Calculate the Allowance for Sampling Risk and the Acceptance Interval

The allowance for sampling risk is calculated as

$$\text{Allowance for Sampling risk} = \text{Tolerable misstatement} - \frac{\left(\text{Population book value} \times \text{Incorrect acceptance coefficient} \times \text{Sample standard deviation} \right)}{\sqrt{\text{Sample size}}}$$

When the auditors calculate the allowance for sampling risk, the client's book value is accepted or rejected based on whether it falls within the acceptance interval constructed by the estimated total audited value (mean audited value $\times$ number of accounts) $\pm$ the allowance for sampling risk. The acceptance interval may be viewed as the range of possible misstatement that is likely to exist in the population at the specified level of sample risk. If the book value falls within the acceptance interval, the sample results support a conclusion that the account balance is materially correct. However, even in this situation, the auditors will consider the misstatements identified to determine both their nature (e.g., is fraud involved, or do misstatements have implications for other accounts) and whether there is reason to still question the accuracy of the account.

If the client's book value does not fall within the acceptance interval, the sample results indicate that the risk of material misstatement is too high. Assuming this is the case, the auditors do not have enough evidence to conclude whether there is a material misstatement in the account at the desired level of risk. They must determine whether the population is actually materially misstated or whether they simply selected a sample that is not representative of the population as a whole. In this situation, the auditors have several options. They may decide to select additional sample items. In doing so, they should use the information from the initial sample to try to efficiently locate other misstated items (if they exist) in the population. As an example, assume that the initial sample revealed a moderate number of errors in wholesale customer accounts but none in retail customer accounts. Then, the auditors may find it efficient to select additional sample items exclusively or primarily from the wholesale accounts and evaluate the results as if the population consisted on two subpopulations: wholesale customer accounts and retail customer accounts. In some cases, data analytics may be used to focus attention on all items with certain characteristics.

Another approach when the auditors need additional evidence is to perform additional substantive procedures directed toward the same audit objectives to obtain enough

evidence about the account. The auditors also may request management to have its staff, with auditor review, examine a large number of population items to determine whether the account is actually materially misstated, and, if appropriate, to adjust the recorded amount. Although additional auditor and management procedures may be expected to resolve the issue, ultimately, if the auditors cannot determine whether the account is materially misstated, they cannot conclude on the fairness of the financial statements.

Finally, the auditors should also qualitatively review the misstatements identified in the sample for indications of fraud or breakdowns in internal control.

The entire sampling procedure is easier to follow through use of an illustration such as the following. For comparison purposes, we use the same audit objectives and population as that in Module 9A. However, it may be considered independently of that module.

Illustration of Mean-Per-Unit Estimation

1. *Determine the objective of the test.* Assume that the auditors wish to send customers confirmation requests to test the existence and gross valuation of recorded accounts receivable of ABC Company, a company that sells inexpensive Internet-related products.
2. *Define the population and sampling unit.* While most of ABC Company's sales are to customers who use credit cards or services such as PayPal, a number of customers are on an approved customer list and are granted credit. Receivables from these customers make up the population of accounts receivable on ABC Company's financial statements. At year-end, this population includes 100,000 uncollected sales invoices from 53,000 customers, recorded at a total book value of \$6,250,000. Based on a belief that it will be easier for customers to confirm individual unpaid purchases rather than their month-end balance due, the auditors decide to confirm a sample of uncollected sales invoices through direct correspondence with the customers rather than confirming account balances. Therefore, each uncollected sales invoice per the accounting records at year-end represents a sampling unit. Figure 9.16 summarizes the sampling units, uncollected sales invoices.
3. *Choose an audit sampling technique.* The auditors have decided to use the mean-per-unit technique applied with unrestricted random selection—that is, they will not stratify the population.
4. *Determine the sample size.* To calculate the required sample size, the auditors must determine (a) the population size (number of sampling items), (b) the tolerable misstatement for the test, (c) the planned levels of sampling risk (the risks of incorrect acceptance and rejection), and (d) the estimate of the population's standard deviation.

FIGURE 9.16
Uncollected Sales
Invoices

ABC COMPANY Population of Uncollected Sales Invoices December 31, 20X3			
Population Item Number	Sales Invoice Number	Account Name	Book Value
1	145617	Bill Jones	\$ 41.58
2	123452	Barrett Slary	69.50
3	142944	Sarah Smoker	44.46
4	124585	Bill Ga	49.31
5	145213	Jane Zhang	63.57
:	:	:	:
:	:	:	:
:	:	:	:
99,999	132027	Barrett Gingin	82.25
100,000	154923	Ringo Starling	99.20
Total book value			\$6,250,000.00
Mean account value			\$ 62.50

Based on their consideration of internal control, the auditors believe that all uncollected sales invoices are included in the client's 100,000 uncollected sales invoices (the physical representation of the population). Because internal control over existence and valuation of accounts receivable is very weak, the auditors assess control risk at the maximum level for those assertions, that is, 100 percent. In addition, they assess inherent risk at 100 percent. Also they plan to perform only very limited additional substantive procedures other than this procedure on these assertions. Therefore, the auditors decide on a 5 percent risk of incorrect acceptance. Based on a consideration of the costs of performing additional procedures when an account is improperly rejected, a 4.6 percent risk of incorrect rejection is planned by the auditors. From this information, the auditors obtain the risk coefficients from Figure 9.15. The auditors use the standard deviation of the book values of the receivable invoices, approximately \$15, as the estimate of the audited value standard deviation. Based on the auditors' consideration of performance materiality for accounts receivable, they specify tolerable misstatement at \$364,000. With this information, the sample size may be computed as

$$\begin{aligned} \text{Sample size} &= \left[\frac{\text{Population size (sampling units)} \times \left[\frac{\text{Incorrect acceptance coefficient}}{\text{Incorrect rejection coefficient}} + \frac{\text{Incorrect rejection coefficient}}{\text{Incorrect acceptance coefficient}} \right] \times \text{Estimated standard deviation}}{\text{Tolerable misstatement}} \right]^2 \\ &= \left[\frac{100,000 \times (1.64 + 2.00) \times 15}{364,000} \right]^2 \\ &= 225 \text{ items (uncollected sales invoices)} \end{aligned}$$

5. *Select the sample.* The auditors' software generates 225 random numbers that correspond to a sequential numbering of the 100,000 population sampling units, selects the corresponding unpaid sales invoices, and prints the confirmation requests.
6. *Test the sample items.* The auditors send the confirmation requests and perform additional procedures as appropriate.
7. *Evaluate the sample results.* Confirmation of the 225 uncollected sales invoices, as summarized in Figure 9.17, results in a sample with a mean audited value of \$61 per account. Figure 9.17 also indicates that the mean book value of the 225 accounts in the sample was \$63. Notice that this \$63 differs somewhat from the mean book value of the entire population, \$62.50, in Figure 9.16. This difference of \$0.50 per account is due to chance and is not directly used in the mean-per-unit analysis. Assume that the standard deviation of the audited items in the sample is \$16.

FIGURE 9.17
Auditors' Sample
Results of Uncollected
Sales Invoices

ABC Company Sample of Uncollected Sales Invoices December 31, 20X3					
Sample Item Number	Sales Invoice Number	Account Name	Book Value	Audited Value	Difference
1	145617	Bill Jones	\$ 41.58	\$ 39.58	\$2.00
2	116920	Sam Slary	66.50	64.50	2.00
3	152946	Sarah Smith	44.46	44.46	0.00
4	124585	Jeno Jennings	49.61	46.21	3.40
5	145213	Barb Rotter	63.67	63.67	0.00
:	:	:	:	:	:
:	:	:	:	:	:
:	:	:	:	:	:
224	132022	Sam Slary	82.50	82.50	0.00
225	154923	Ringo Starling	99.20	92.00	7.20
Total			\$14,175.00	\$13,725.00	\$450.00
Mean			\$63.00	\$61.00	\$ 2.00

The calculation of the account's estimated total audited value is intuitively logical: It simply uses average audited value in the sample (\$61) as the estimate of the average audited account value in the entire population of 100,000 uncollected sales invoices. Accordingly, the estimated total audited value of accounts receivable may be calculated as

$$\begin{aligned}\text{Estimated total audited value} &= \text{Mean audited value} \times \text{Population items} \\ &= \$61 \times 100,000 \text{ uncollected sales invoices} \\ &= \$6,100,000\end{aligned}$$

The projected misstatement is the difference between the estimated total audited value (\$6,100,000) and the population value (\$6,250,000), which is calculated as

$$\begin{aligned}\text{Projected misstatement} &= \text{Estimated total audited value} - \text{Book value of population} \\ &= \$6,100,000 - \$6,250,000 \\ &= \$150,000 \text{ overstatement}\end{aligned}$$

Thus, the mean-per-unit estimate of the most likely misstatement amount in the population is \$150,000. But the amount of misstatement may be higher or lower than that amount. Calculation of the allowance for sampling risk will provide the auditors with the basis for a statistical conclusion on whether sufficient appropriate audit evidence has been obtained to conclude at the specified risk of incorrect acceptance that the account is not materially misstated.

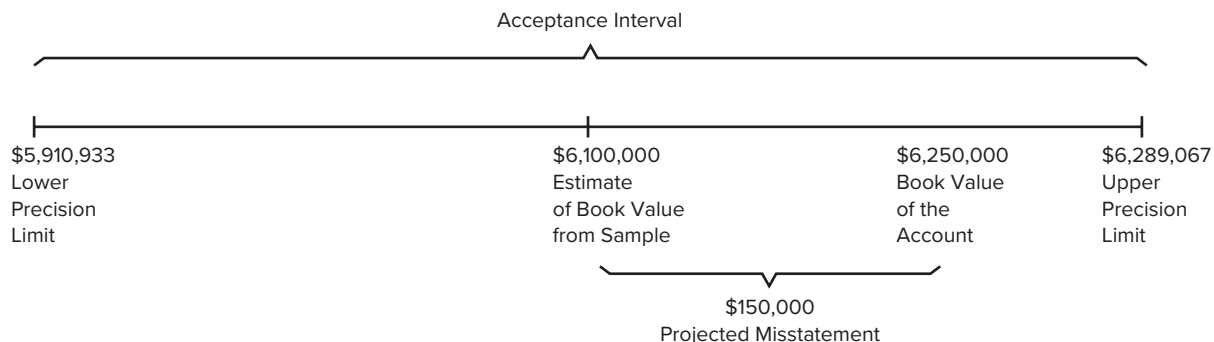
The allowance for sampling risk is calculated as

$$\begin{aligned}\text{Allowance for sampling risk} &= \text{Tolerable misstatement} - \frac{\left(\text{Population items} \times \frac{\text{Incorrect acceptance coefficient}}{\sqrt{\text{Sample size}}} \times \text{Sample standard deviation} \right)}{\sqrt{\text{Sample size}}} \\ &= \$364,000 - \frac{(100,000 \times 1.64 \times 16)}{\sqrt{225}} \\ &= \$364,000 - \$174,933 \\ &= \$189,067\end{aligned}$$

Thus, the acceptance interval would be constructed as \$6,100,000 $\pm$ \$189,067 (\$5,910,933 to \$6,289,067). As illustrated by Figure 9.18, the client's book value (\$6,250,000) falls within this interval. Therefore, the sample results indicate that the account does not contain a material misstatement.

As in other types of sampling, the auditors should consider the qualitative aspects of any misstatements found in their sample. "What caused the misstatements that were discovered?" "Do any of the misstatements indicate fraud?" and "What are the implications of the misstatements for other audit areas?" are questions the auditors should

FIGURE 9.18 Acceptance Interval for Substantive Procedure (sample audited standard deviation equal to \$16)



attempt to answer in their qualitative evaluation of results. Also, as is discussed in Chapter 16, the projected misstatement of \$150,000 will be considered in the auditors' analysis of less than material misstatements.¹¹

If the population's book value (\$6,250,000) was outside the interval, the sample results would not support a conclusion that the population is materially correct at the desired risk levels. In this case, the auditors must get additional information about the fairness of the account. For example, the auditors may sample additional items or perform additional substantive tests to obtain evidence about the account.

8. *Document the sampling procedures.* Each of the prior seven steps, as well as the basis for overall conclusions, should be documented in the auditors' working papers. This documentation should include an identification of the items tested.

Difference and Ratio Estimation

Mean-per-unit estimation uses the mean audited value of the sample as the basis for estimating the projected misstatement and total audited value of a population. Two other options are difference and ratio estimation. Although closely related, difference estimation and ratio estimation are two distinct sampling plans; each is appropriate under slightly different circumstances.

In applying difference estimation, the auditors use a sample to estimate the average difference between the audited value and book value of items in a population. The average difference is estimated by dividing the net misstatement in the sample by the number of items in the sample.¹² The projected misstatement is determined by multiplying the estimated average difference by the number of items in the population. This may be viewed as

$$\text{Projected misstatement} = \left(\frac{\text{Sample net misstatement}}{\text{Sample items}} \right) \times \text{Population items}$$

The estimated total audited value is equal to the book value of the account plus or minus the projected misstatement, depending upon whether the misstatement is an understatement or an overstatement.

In ratio estimation, the auditors use a sample to estimate the ratio of the misstatement in a sample to its book value and project it to the entire population.¹³ The ratio of misstatements is simply the sample net misstatement divided by the book value of the items in the sample. An estimate of the projected misstatement is obtained by multiplying this estimated ratio by the total population book value, as illustrated below:

$$\text{Projected misstatement} = \left(\frac{\text{Sample net misstatement}}{\text{Book value of sample}} \right) \times \text{Population book value}$$

¹¹ Notice from Figure 9.11 that the auditors have found only \$450 of misstatements in their sample (\$14,175 book value minus \$13,725 audited value) and projected a total amount of \$150,000 as the most likely misstatement in the entire account. Because only \$450 of misstatements have been identified, it is not as simple as adjusting various misstated accounts for the total of \$150,000 because most misstatements have not been identified. This is discussed further in Chapter 16. Also, the projected misstatement may be decreased by the total of the corrected misstatements.

¹² Symbolically, the estimated average difference is computed as follows:

$$\hat{d} = \frac{1}{n} \sum_{j=1}^n (a_j - b_j)$$

where $\hat{d}$ (pronounced *d* caret) represents the estimated average difference between audited value (a_j) and book value (b_j) of each sample item.

¹³ Symbolically, this process is expressed:

$$\hat{R} = \frac{\sum (a_j - b_j)}{\sum b_j}$$

where $\hat{R}$ represents the estimated ratio of misstatement to book value, a_j represents the audited value of each sample item, and b_j represents the book value of each sample item.

Alternatively, identical results are obtained by using the average misstatement in the sample, divided by the average book value in the sample, and multiplying times the total population book value, as illustrated below:

$$\text{Projected misstatement} = \left(\frac{\text{Sample average misstatement}}{\text{Sample average book value}} \right) \times \text{Population book value}$$

The estimated total audited value equals the book value of the account plus or minus the projected misstatement, depending upon whether the misstatement is an understatement or an overstatement.

Use of Difference and Ratio Estimation

The use of difference and ratio estimation techniques requires that (1) each population item has a book value, (2) an audited value may be determined for each sample item, and (3) differences between audited and book values (misstatements) are relatively frequent. If the occurrence rate of misstatements is very low, a prohibitively large sample is required to disclose a representative number of misstatements. When these requirements are met, ratio estimation or difference estimation is often more efficient than mean-per-unit estimation.

Difference estimation is most appropriate when the size of misstatements does not vary significantly in comparison to book value. This might be the case when errors are occurring randomly, independently of account size.

Ratio estimation is preferred when the size of misstatements is nearly proportional to the book values of the items. That is, it is appropriate when larger accounts have large misstatements and smaller accounts have small misstatements. For example, this might often be the case for receivables—small accounts might be expected to have small misstatements in dollar terms and large accounts to have large misstatements in dollar terms.

Illustration of Difference and Ratio Estimation

The information presented in Figures 9.16 and 9.17 may be used to illustrate the use of difference and ratio estimation techniques. Recall that the population consists of 100,000 accounts with an aggregate book value of \$6,250,000; Figure 9.17 indicates that the total book and audited values of the sample are, respectively, \$14,175 and \$13,725. The auditors calculate the required sample size, randomly select the accounts to be sampled, and apply auditing procedures to determine the correct account balances. In actuality, differences in the sample size formulas¹⁴ would cause the sample size to differ from that obtained using the mean-per-unit method, but in this illustration we will continue to assume a sample size of 225, as summarized in Figure 9.16.

Difference Estimation

If difference estimation is used, the auditors would estimate the average difference per item to be a \$2 overstatement (\$450 ÷ 225 items). Multiplying the \$2 by the 100,000 accounts in the population indicates that the projected misstatement for accounts receivable is a \$200,000 overstatement, as calculated below:

$$\begin{aligned} \text{Projected misstatement} &= \left(\frac{\text{Sample net misstatement}}{\text{Sample items}} \right) \times \text{Population items} \\ &= \frac{\$450}{225} \times 100,000 \\ &= \$2 \times 100,000 \\ &= \$200,000 \end{aligned}$$

¹⁴ The major differences in the formulas are that the standard deviations used would be those for the ratios and differences.

The estimated total audited value of the account is calculated as follows:

$$\begin{aligned}\text{Estimated total audited value} &= \text{Population book value} - \text{Projected overstatement} \\ &= \$6,250,000 - \$200,000 \\ &= \$6,050,000\end{aligned}$$

Ratio Estimation

For ratio estimation, the auditors would estimate the projected misstatement using the following formula:

$$\begin{aligned}\text{Projected misstatement} &= \left(\frac{\text{Sample net misstatement}}{\text{Book value of sample}} \right) \times \text{Population book value} \\ &= \left(\frac{\$450}{\$14,175} \right) \times \$6,250,000 = \$198,413\end{aligned}$$

Alternatively, averages may be used as follows:

$$\begin{aligned}\text{Projected misstatement} &= \left(\frac{\text{Sample average misstatement}}{\text{Sample average book value}} \right) \times \text{Population book value} \\ &= \left(\frac{\$2}{\$63} \right) \times \$6,250,000 = \$198,413\end{aligned}$$

Because the projected misstatement indicates an overstatement, this difference is subtracted from the book value to obtain the estimated total audited value as follows:

$$\begin{aligned}\text{Estimated total audited value} &= \text{Population book value} - \text{Projected overstatement} \\ &= \$6,250,000 - \$198,413 \\ &= \$6,051,587\end{aligned}$$

If the projected misstatement had been an understatement, the amount would have been added to the population book value.

Formulas are available for both difference and ratio estimation to calculate an allowance for sampling risk to control sampling risk in a manner similar to the mean-per-unit method. However, we do not take the analysis further than the calculation of projected misstatement and the estimated total audited value.

Questions and Problems for Module 9B

Review Questions

(LO 9-8 unless indicated): Plan, perform, and evaluate samples for substantive procedures using classical variables sampling.

- 9B-1. Explain how the auditors may obtain an estimate of a population's standard deviation to determine an appropriate sample size.
- 9B-2. Comment on the following: When using mean-per-unit sampling, increases in the tolerable misstatement result in an increased required sample size.
- 9B-3. When using statistical sampling to evaluate results using mean-per-unit sampling, may one conclude at the tested risk levels that an account is not materially misstated whenever the projected misstatement is less than the tolerable misstatement?
- 9B-4. The mean of the audited values in a sample is \$20. The accounts in that sample have a mean book value of \$21, and the entire population of 10,000 accounts has an average book value of \$19. Using mean-per-unit sampling, calculate the estimated total audited value of the account.
- 9B-5. What conditions are necessary for the auditors to use either the ratio or difference estimation techniques?
- 9B-6. What options are available to an auditor when the client's book value falls outside the confidence (acceptance) interval calculated using the estimate of the total value of the population?
- 9B-7. Explain how, in using the mean-per-unit method to evaluate results, the auditors use the differences between the audited values and the book values of the individual items in their sample.

Questions Requiring Analysis

Select questions are available with Connect



- 9B-8 Linda Williams is auditing the financial statements of Western Industries. In the performance of mean-per-unit estimation of credit sales, Williams took a sample of 200 of the 10,000 items in the population (book value \$6,000,000). The sample's average book value is \$595, and the average audited value is \$590. Calculate the projected misstatement in the population.
- 9B-9. Ratio estimation and difference estimation are two widely used variables sampling plans.
- Under what conditions are ratio estimation or difference estimation appropriate sampling plans for estimating the total dollar value of a population?
 - What relationship determines which of these two plans will be most efficient in a particular situation?
- 9B-10. During an audit of Rottel Company, an auditor needs to estimate the total value of the 5,000 invoices processed during June. She estimates the standard deviation of the population to be \$45. Determine the size of the sample the auditor would select when using mean-per-unit sampling and
- Tolerable misstatement = \$45,500
 - Risk of incorrect acceptance = 5.0 percent
 - Risk of incorrect rejection = 4.6 percent

Objective Questions

9B-11. Multiple Choice Questions

- Select the best answer for each of the following questions. Explain the reasons for your selection.
- The auditors are using unstratified mean-per-unit sampling to audit accounts receivable as they did in the prior year. Which of the following changes in characteristics or specifications would result in a larger required sample size this year than that required in the prior year?
 - Larger variance in the dollar value of accounts.
 - Smaller population size.
 - Larger tolerable misstatement.
 - Higher risk of incorrect acceptance.
 - An auditor needs to estimate the average highway weight of tractor-trailer trucks using a state's highway system. Which estimation method is most appropriate?
 - Mean per unit.
 - Difference.
 - Ratio.
 - Attributes.
 - The auditors have sampled 50 accounts from a population of 1,000 accounts receivable. The sample items have a mean book value of \$200 and a mean audited value of \$203. The book value in the population is \$198,000. What is the estimated audited value of the population using the mean-per-unit method?
 - \$198,000.
 - \$200,000.
 - \$201,000.
 - \$203,000.
 - Using the same facts as in (c) above, what is the estimated total audited value of the population using the difference method?
 - \$198,000.
 - \$200,000.
 - \$201,000.
 - \$203,000.
 - Using the mean-per-unit estimation method, an auditor has properly calculated the estimated total audited value of a population as \$400,000. Her sample included 200 of the

population's 40,000 items. She found that, in her sample, the average audited value was \$2 more than the average book value. What was the average book value in the sample?

- (1) \$8
- (2) \$10
- (3) \$12
- (4) \$14

9B-12. The 10 following statements apply to unrestricted random sampling without replacement. Indicate whether each statement is true or false. Briefly discuss each false statement.

- a. When sampling from the population of accounts receivable for certain objectives, the auditor might sample only active accounts with balances.
- b. To be random, every item in the population must have an equal chance of being selected for inclusion in the sample.
- c. In general, all items in excess of a material misstatement need to be examined and sampling of them is inappropriate.
- d. It is likely that five different random samples from the same population could produce five different estimates of the true population mean.
- e. A 100 percent sample would have to be taken to eliminate sampling risk.
- f. The effect of the inclusion by chance of a very large or very small item in a random sample can be lessened by increasing the size of the sample.
- g. The standard deviation is a measure of the variability of items in a population.
- h. The larger the standard deviation of a population, the smaller the required sample size.
- i. Unrestricted random sampling with replacement may result in a larger sample size than unrestricted random sampling without replacement.
- j. Unrestricted random sampling normally results in a smaller sample size than does stratified sampling.

9B-13. For each term in the first column below, identify its definition (or partial definition). Each definition may be used once or not at all.

Term	Definition (or Partial Definition)
a. Allowance for sampling risk	1. A classical variables sampling plan enabling the auditors to estimate the average dollar value (or other variable) of items in a population by determining the average value of items in a sample.
b. Deviation rate	2. A defined rate of departure from prescribed controls. Also referred to as <i>occurrence rate</i> or <i>exception rate</i> .
c. Discovery sampling	3. A sampling plan enabling the auditors to estimate the rate of deviation (occurrence) in a population.
d. Projected misstatement	4. A sampling plan for locating at least 1 deviation, providing that the deviation occurs in the population with a specified frequency.
e. Reliability	5. A sampling plan in which the sample is selected in stages, with the need for each subsequent stage being conditional on the results of the previous stage.
f. Risk of assessing control risk too low	6. Also referred to as <i>precision</i> , a measure of the difference between a sample estimate (projection) and the tolerable rate of deviation or tolerable misstatement at a specified sampling risk.
g. Risk of incorrect acceptance	7. An estimate of the most likely amount of monetary misstatement in a population.
h. Sampling risk	8. The complement of the risk of incorrect acceptance.
i. Tolerable deviation rate	9. The maximum population rate of deviations from a prescribed control that the auditors will accept without modifying the planned assessment of control risk.
	10. The possibility that the assessed level of control risk based on the sample is less than the true operating effectiveness of the controls.
	11. The possibility that the assessed level of control risk based on the sample is greater than the true operating effectiveness of the control.
	12. The risk that sample results will indicate that a population is materially misstated when, in fact, it is not.
	13. The risk that sample results will indicate that a population is not materially misstated when, in fact, it is materially misstated.
	14. The risk that the auditors' conclusion based on a sample might be different from the conclusion they would reach if the test were applied to the entire population.

9B-14. **Little, Inc.**

Brittany Petrof wishes to use mean-per-unit sampling to evaluate the reasonableness of the book value of the accounts receivable of Little, Inc. Little has 10,000 receivable accounts with a total book value of \$1,500,000. Petrof estimates the population's standard deviation to be equal to \$25. After examining the overall audit plan, Petrof believes that the account's tolerable misstatement is \$60,000 and that a risk of incorrect rejection of 5 percent and a risk of incorrect acceptance of 10 percent are appropriate.

a. Calculate the required sample size.

b. Assuming the following results:

Book value of items in sample = \$149

Average audited value of items in sample = \$146

Standard deviation of sample = \$28

use the mean-per-unit method to:

- (1) Calculate the point estimate of the account's audited value.
- (2) Calculate the projected misstatement for the population.
- (3) Calculate the adjusted allowance for sampling risk.
- (4) State the auditors' conclusion in this situation (accept or reject).

Use the following replies for the above questions—replies may be used once, more than once, or not at all. In all cases, select the reply closest to your answer.

	Replies
Sample size (a)	10. \$40,000
1. 14 accounts.	11. \$1,360,423
2. 112 accounts	12. \$1,460,000
3. 183 accounts	13. \$1,469,799
4. 263 accounts	14. \$1,470,000
Other replies for (b)	15. \$1,530,000
5. \$549	16. \$1,530,201
6. \$30,000	17. Accept population—conclude the risk that it is materially misstated is appropriately low.
7. \$30,201	18. Reject population—conclude the risk that it is materially misstated is too high.
8. \$33,506	
9. \$34,602	

9B-15. **Little Inc.: Ratio and Difference Estimation**

Note: This problem uses the information presented in the previous question and extends the analysis to ratio and difference estimation.

Use the replies presented in the preceding problem for this problem.

a. Use the ratio method to calculate:

- (1) Projected misstatement.
- (2) Estimated total audited value.

b. Use the difference estimation method to calculate:

- (1) Projected misstatement.
- (2) Estimated total audited value.

Problems

9B-16. James Duffney, CPA, has randomly selected and audited a sample of 100 of Will-Mart's accounts receivable. Will-Mart has 6,000 accounts receivable accounts with a total book value of \$6,000,000. Duffney has determined that the account's tolerable misstatement is \$500,000. His sample results are as follows:

Average audited value	\$990
Average book value	998

Calculate the accounts receivable estimated audited value and projected misstatement using the:

- (a) Mean-per-unit method.
- (b) Ratio method.
- (c) Difference method.

- 9B-17. You are the auditor of Unet Inc., an auto air-conditioner service and repair company, and you have decided to use the mean-per-unit method to test the existence and gross valuation of recorded accounts receivable. The client's records include 10,000 accounts with a total book value of \$2,500,000. You decide to use tolerable misstatement of \$182,000, an incorrect acceptance risk of 5 percent, and an incorrect rejection risk of 4.6 percent. Using Excel, you estimated the standard deviation of the population as \$100.
- a. Determine the sample size.
 - b. Assume you tested the sample and got the following results: The mean audited value of the accounts in the sample was \$244. Assuming that the standard deviation of the sample's audited value is also \$100, will you accept the account as not being materially misstated? What is the projected misstatement for the population?
 - c. Assuming that the standard deviation of the sample's audited value is \$125, will you accept the account as not being materially misstated? Show your calculations. What is the projected misstatement for the population?
- 9B-18. In the audit of Western Mills, the auditors wish to test the costs assigned to manufactured goods. During the year, the company has produced 2,000 production lots with a total recorded cost of \$5.9 million. The auditors select a sample of 200 production lots with an aggregate book value of \$600,000 and vouch the assigned costs to the supporting documentation. Their audit discloses misstatements in the cost of 52 of the 200 production lots; after adjustment for these misstatements, the audited value of the sample is \$582,000.
- a. Show how the auditors would compute an estimate of the total cost of production lots manufactured during the year using each of the following sampling plans. (Do not compute the allowance for sampling risk or the risk of incorrect acceptance of the estimates.)
 - (1) Mean-per-unit estimation.
 - (2) Ratio estimation.
 - (3) Difference estimation.
 - b. Explain why mean-per-unit estimation results in a higher estimate of the population value than does ratio estimation in this particular instance.
- 9B-19. To test the pricing and mathematical accuracy of sales invoices, the auditors selected a sample of 200 sales invoices from a total of 41,600 invoices that were issued during the year under audit. The 200 invoices represented total recorded sales of \$22,800. Total sales for the year amounted to \$5 million. The test disclosed that of the 200 invoices audited, five were not properly priced or contained errors in extensions and footings. The five incorrect invoices represented \$720 of the total recorded sales, and the errors found resulted in a net understatement of these invoices by \$300.

Explain what conclusions the auditors may draw from the above information, assuming the sample was selected:

- a. As part of a ratio estimation plan for estimating the total population value.
 - b. As part of a difference estimation plan for estimating the total population value.
 - c. As part of an attributes sampling plan using a stipulated tolerable deviation rate of 5 percent and a risk of assessing control risk too low of 5 percent.
- 9B-20. **Module 9B (parts a, c, d, e), Chapter 9 (parts b, f), and Module 9A (part g)**
 Bill Pei, CPA, is about to begin his audit of the accuracy of his client's accounts receivable. Based on experience, he expects that approximately 1 percent of the client's 40,000 accounts have errors. The total book value of receivables is \$5 million. Pei has established \$390,000 as the amount of tolerable misstatement, 5 percent for the risk of incorrect acceptance, and 10 percent for the risk of incorrect rejection. The auditor estimates the standard deviation of the accounts to be \$45.

Integrating Problem

- a. Using mean-per-unit sampling, calculate the required sample size.
- b. Now ignore requirement (a). Assume that as part of an attributes sampling plan using a tolerable deviation rate of 5 percent and a risk of assessing control risk too low of 5 percent, the auditor wishes to test the receivables valuation—that is, each account will be considered as either correct or a deviation. What sample size would be required for this test?

Additional information for requirements (c) through (g):

Now ignore your requirement (a) and (b) answers and assume that the auditor selected a random sample of 208 accounts, representing a total book value of receivables of \$40,800. He found five errors, representing a \$20,300 overstatement as follows:

Misstatement	Book Value	Audited Value
1	\$26,000	\$ 5,950
2	1,000	900
3	220	200
4	180	120
5	100	30
	<u>\$27,500</u>	<u>\$ 7,200</u>

The standard deviation of the book value of the sample was \$50, while the standard deviation of the audited values of the sample was \$55.

- c. Using mean-per-unit estimation, what is the projected misstatement for the population?
- d. Using mean-per-unit sampling, calculate the allowance for sampling risk and use it to calculate the appropriate interval for use in deciding whether to “accept” or “reject” the population.
- e. Using difference estimation, calculate the projected misstatement for the population.
- f. Given five misstatements, what statistical conclusion may be made using attributes sampling?
- g. Assume a sampling interval of \$24,038 (\$5,000,000/208). Using MUS, calculate:
 1. Projected misstatement.
 2. Basic precision.
 3. Incremental allowance for sampling risk.
 4. Upper limit on misstatement.

Module 9C

Nonstatistical Sampling for Substantive Procedures

LO 9-9

Plan, perform, and evaluate samples for substantive procedures using nonstatistical sampling. (Module 9C)

All audit sampling, nonstatistical or statistical, involves judgment in planning and performing the sampling procedures. The major differences between nonstatistical and statistical sampling in substantive testing are in the procedures used to determine the sample size and evaluate the sample results. In using nonstatistical sampling, the auditors may decide not to quantify the factors used to arrive at the sample size, although they will consider the relationships that are summarized in Figure 9.8.

In evaluating the sample results, for both nonstatistical and statistical sampling, auditors calculate a projected misstatement (less any corrections the client has recorded) and conclude whether the amount is sufficiently lower than tolerable misstatement. While the auditors may use unassisted judgment for determining the sample size and for evaluating the sample results, many CPA firms have adopted structured approaches to nonstatistical sampling that are based on statistical methods. This increases the consistency of sampling judgments that are made by various auditors throughout the firm. That is the approach used in the following illustration.

Illustration of Nonstatistical Sampling

The following example illustrates the use of a structured nonstatistical sampling plan.

1. *Determine the objective of the procedures.* Auditors ordinarily are addressing the reasonableness of one or more assertions about a financial statement amount. For example, assume that the auditors are performing a test of the valuation of inventory by testing the pricing of a sample of inventory items by reference to vendors' invoices. The inventory consists of 2,000 items with a book value of \$3,000,000.
2. *Define the population and sampling unit.* The physical representation of the population consists of a listing of the inventory items on hand at year-end, and the auditors have determined that the sampling unit will be each individual product.
3. *Choose the audit sampling technique.* The auditors have decided to use a structured approach to nonstatistical sampling. They could have chosen monetary unit sampling (discussed in Module 9A) or classical variables sampling (Module 9B).
4. *Determine the sample size.* Although an auditor may judgmentally determine sample size, another approach to nonstatistical sampling is to use the following formula:¹⁵

$$\text{Sample size} = \frac{\text{Population book value} \times \text{Reliability factor}}{\text{Tolerable misstatement}}$$

The **reliability** factor for the formula is selected from a table such as the one that is illustrated by Figure 9.19. It is based on the auditors' combined assessment of inherent and control risk and the auditors' assessment of the risk that other substantive procedures will fail to detect a material misstatement of the assertions. Both risks are assessed on qualitative scales from maximum risk (100 percent) to low risk.

In our example, assume that the auditors have assessed the combination of inherent and control risk at slightly below the maximum. They have also performed analytical procedures on the inventory account that the auditors believe have a moderate risk of not detecting a material misstatement in the valuation of the inventory account. Using these assessments of risk, the auditors obtain a reliability factor of 2.0 using Figure 9.19. If the auditors have decided that \$100,000 is the amount of tolerable misstatement for the test, the sample size would be calculated as follows:

$$\begin{aligned} \text{Sample size} &= \frac{\text{Population book value} \times \text{Reliability factor}}{\text{Tolerable misstatement}} \\ &= \frac{\$3,000,000 \times 2.0}{\$100,000} \\ &= 60 \text{ items} \end{aligned}$$

FIGURE 9.19
Reliability Factors for
Nonstatistical Sampling
Plan

Combined Assessment of Inherent and Control Risk	Risk That Other Substantive Procedures (e.g., Analytical Procedures) Will Fail to Detect a Material Misstatement		
	Maximum	Moderate	Low
Maximum	3.0	2.3	1.9
Slightly below maximum	2.7	2.0	1.6
Moderate	2.3	1.6	1.2
Low	1.9	1.2	1.0

Note: This table is applicable when the auditors expect few misstatements in the population.

¹⁵ We provide a very basic approach for (1) sample size determination and (2) sample evaluation. For example, the formula implicitly assumes no expected misstatement in the population. One method to recognize an amount of expected misstatement is to decrease the tolerable misstatement by that expected amount (and thereby increase sample size).

See the AICPA *Audit Sampling Guide* for detailed assistance. The *Guide* also provides guidance for (1) stratification and (2) control at numerical levels of the risk of incorrect acceptance.

5. *Select the sample.* Because of limited variability in individual account balances, the auditors have decided to select a random sample. Often, however, they will select the sample on a stratified basis, emphasizing accounts with higher values.
6. *Test the sample items.* The auditors examine vendors' invoices supporting the price of each product selected for testing. Assume that the auditors' sample includes
 - Four products that were priced at improper prices, resulting in a total overstatement of the account of \$540. The misstatements represent an average overstatement of \$9 per sampling unit (\$540 overstatement ÷ 60 items).
 - The total book value of the sample is \$89,900 (\$1,498.33 per item) and the total audited value is \$89,360 (\$1,489.33 per item).
7. *Evaluate the sample results.* In evaluating the sample results, the auditors will begin by projecting the misstatements found in the sample to the population. A number of methods may be used, including (1) ratio projection, (2) difference projection, and (3) average audited value projection. In each of the methods, the result will be applied to the entire population that is being sampled. Most frequently, the auditors select one of the first two options. In this situation, they have chosen to use ratio projection.

Ratio projection

Ratio projection uses the percentage of misstatement in the sample to project results ([sample misstatement ÷ sample book value] × Population book value). In this example, the auditors decide to use ratio projection, as illustrated:

$$\begin{aligned}
 \text{Projected misstatement} &= \frac{\text{Sample net misstatement}}{\text{Sample book value}} \times \text{Population book value} \\
 &= \frac{\$540}{\$89,900} \times \$3,000,000 \\
 &= \$18,020
 \end{aligned}$$

After calculating the projected misstatement in the population, the auditors will then compare that amount with the amount of tolerable misstatement. In this situation, the auditors compare \$18,020 with \$100,000 and use professional judgment to evaluate whether there is a sufficiently low risk of material misstatement of the account. In essence, the \$18,020 allows for up to \$81,980 (\$100,000 tolerable misstatement – \$18,020 projected misstatement) for the allowance for sampling risk and for any undetected misstatements. Because the projected misstatement is only approximately 18 percent (\$18,020 ÷ \$100,000) of tolerable misstatement, the auditors would likely conclude that the account balance is acceptable.

As the amount of projected misstatement gets closer to the amount of tolerable misstatement for the account, the auditors are more likely to conclude that the risk of material misstatement is too high. When the auditors conclude that the risk of misstatement is high, they will not accept the client's book balance as being materially correct and will either convince the client to adjust the book value or perform additional audit tests on the population.

The auditors will also perform a qualitative evaluation of the misstatements found in the population to determine if there are implications for other aspects of the audit. Intentional misstatements would generally have greater implications for the audit than clerical errors.¹⁶

¹⁶ If the auditors had identified a number of items in the population that they considered individually significant (e.g., perhaps three accounts exist that have much higher book balances than the other accounts), they could have audited in detail those three accounts. The sampling would thus be of the 1,997 other accounts with a total book value of \$3,000,000 minus the book values of the three accounts. Any misstatements identified in the three accounts would be added to the sample projected misstatement results.

Difference projection

Had the auditors chosen to use the difference projection, they would have calculated the projected misstatement as the mean misstatement in the sample (\$9 from Step 6 above) times the population's 2,000 items:

$$\begin{aligned}\text{Projected misstatement} &= \text{Average misstatement} \times \text{Population items} \\ &= \$9 \times 2,000 \text{ items} \\ &= \$18,000\end{aligned}$$

8. *Document the sampling procedures.* Each of the prior seven steps, as well as the basis for overall conclusions, should be documented in the auditors' working papers. This documentation should include an identification of the items tested.

Questions and Problems for Module 9C

Note: All questions and problems emphasize LO 9-9: Plan, perform, and evaluate samples for substantive procedures using nonstatistical sampling.

Review Questions

- 9C-1. Is it correct to say that when using nonstatistical variables sampling, one is unable to project the misstatements identified to the entire population? Explain why this is or is not the case.
- 9C-2. When using nonstatistical sampling, what relationship must exist between the projected misstatement and tolerable misstatement in order for the auditors to conclude that an account balance is acceptable?
- 9C-3. An auditor used a nonstatistical sampling plan to audit the inventory of an auto supply company. The auditor tested the recorded cost of a sample of inventory items by reference to vendors' invoices. In performing the test, the auditor verified all the items on two pages selected at random from the client's 257-page inventory listing. The sampling plan resulted in a test of \$400,000 of the total book value of \$40,000,000, and the auditor found a total of \$20,000 in overstatements in the sample. Because the senior indicated that the amount of a material misstatement in the inventory account was \$1,000,000, the auditor concluded that the recorded inventory value was materially correct.

Evaluate the auditor's sampling plan and the manner in which the results were evaluated.

- 9C-4. John Wilson wishes to use nonstatistical sampling to select a sample of his client's 3,000 accounts receivable, which total \$4,500,000. He believes that \$225,000 represents a reasonable tolerable misstatement. He also has assessed both the combination of inherent and control risk at the maximum level and the risk that other substantive procedures will fail to detect a material misstatement at the maximum. He wishes to use a structured approach. Use the formula presented in the text to calculate the required sample size.

9C-5. **Multiple Choice Questions**

Select the best answer for each of the following questions. Explain the reasons for your selection.

- a. Which of the following is required in nonstatistical variables sampling?
- (1) The ratio method of evaluation of results must be used.
 - (2) Sample results should be projected to the population.
 - (3) Statistical sampling formulas or tables must be used to determine sample size.
 - (4) The population being sampled should have a small standard deviation.

Questions Requiring Analysis

Objective Questions

- b. A decrease in the tolerable misstatement amount has what effect on required sample size for nonstatistical variables sampling?
- (1) Smaller required sample size.
 - (2) The same required sample size.
 - (3) Larger required sample size.
 - (4) Indeterminate effect on required sample size.
- c. Which of the following is correct with respect to nonstatistical variables sampling?
- (1) Its use is restricted to situations in which the audit is not subject to peer review.
 - (2) While one may obtain a sample size, it is impossible to evaluate results.
 - (3) Sample size may be determined without the use of tables or formulas.
 - (4) It is an unacceptable technique.
- d. Assume a sample's book value is in excess of its audited value. In nonstatistical variables sampling, what effect does an increase in the book value of the sample items (with no change in audited values) have on the projected misstatement when difference estimation is used to evaluate results?
- (1) Decrease.
 - (2) Increase.
 - (3) Indeterminate.
 - (4) No effect.
- e. In a nonstatistical variables sample, the projected misstatement is \$199,922, while the tolerable misstatement is \$200,000. Which statistical conclusion is most likely correct concerning the risk of material misstatement?
- (1) Low.
 - (2) Moderate.
 - (3) High.
 - (4) Impossible to determine since the tolerable misstatement and the projected misstatement do not relate to one another.

Problems

- 9C-6 The auditors of Kansas Corporation wish to use a structured approach to nonstatistical sampling to evaluate the reasonableness of the accounts receivable. Kansas has 30,000 receivable accounts with a total book value of \$5,000,000. The auditors have assessed the combined level of inherent and control risk at a moderate level and believe that their other substantive procedures are so limited as to require a "maximum" risk assessment. After considering the overall audit plan, the auditors believe that the test's tolerable misstatement is \$86,500.

- a. Calculate the required sample size.
- b. Assuming the following results:

Number of items in sample	200
Total audited value of sample items	\$32,200
Total book value of sample items	\$34,000

- (1) Use the ratio estimation method to calculate the projected misstatement of the population.
 - (2) Use the difference estimation method to calculate the projected misstatement of the population.
- c. Use the results obtained in requirement (b) to arrive at a conclusion as to whether to "accept" or "reject" the population.

- 9C-7. The auditors wish to test the valuation of accounts receivable in the audit of Princeton Corporation. The client has \$1,000,000 of total recorded receivables, composed of 2,000 accounts. The auditors have decided to use structured nonstatistical sampling and have determined the following:

Tolerable misstatement	\$50,000
Assessment of inherent and control risk	Moderate
Risk related to other substantive procedures	Moderate

- Calculate the required sample size.
- Assume that the auditors have tested the sample and discovered three misstatements:

Book Value	Audited Value
\$100	\$90
512	600
900	520

The remainder of the sample had an average value (book and audited) of \$501.00. Calculate the projected misstatement of the population.

- Use the results obtained in requirement (b) to come to a conclusion about whether to “accept” or “reject” the population.

Appendix

Audit Risk

Recall that **audit risk** in essence is the risk that the auditors will issue an unmodified (unqualified) opinion on financial statements that are materially misstated. It consists of two parts: the **risks of material misstatement** in the financial statements and the *risk that the auditors will not detect such misstatement*. The professional standards consider risks at two levels: (1) the financial statement level and (2) the assertion level for account balances, classes of transactions, and disclosures. In this appendix, we will emphasize the risk at the assertion level.

What level of risk of incorrect acceptance is acceptable for a substantive procedure? Based on the discussion in Chapter 5, we know that the extent of substantive procedures is determined by the risk of material misstatement (inherent and control risk) for the assertions being tested. This relationship was illustrated by the formula for audit risk that follows:

$$AR = IR \times CR \times DR$$

where

AR = Audit risk, the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.

IR = Inherent risk, the risk of a material misstatement of a financial statement assertion before considering any related controls.

CR = Control risk, the risk that a material misstatement could occur in a financial statement assertion and not be prevented, or detected and corrected, on a timely basis by internal control.

DR = Detection risk, the risk that the auditors' procedures will lead them to conclude that a financial statement assertion is not materially misstated when in fact such misstatement does exist.

Because substantive procedures may consist of both tests of details using sampling and other types of substantive procedures, such as analytical procedures, one modification of this formula is necessary to calculate the risk of incorrect acceptance for a substantive procedure. Detection risk must be separated into two components:

AP = The risk that analytical procedures and any other substantive procedures not using audit sampling will fail to detect a material misstatement.

TD = The allowable risk of incorrect acceptance for the substantive test of details.

With this modification, the revised formula is presented below:

$$AR = IR \times CR \times AP \times TD$$

Mathematically, we may rearrange the terms in the formula as follows to solve for the appropriate risk of incorrect acceptance for the substantive test of details:

$$TD = \frac{AR}{IR \times CR \times AP}$$

To illustrate, assume that the auditors are willing to accept a 5 percent audit risk of material misstatement in the assertion of existence of the client's accounts receivable. They believe that the inherent risk of that assertion is 100 percent. After considering internal control over the revenue cycle, they assess control risk at a level of 50 percent, and they believe that the analytical procedures performed to test the assertion have a 40 percent risk of failing to detect a material misstatement. The appropriate level of risk of incorrect acceptance may be calculated as follows:

$$\begin{aligned} TD &= \frac{AR}{IR \times CR \times AP} \\ &= \frac{.05}{(1.00) \times (.50) \times (.40)} \\ &= .25 \end{aligned}$$

Thus, the auditors should plan an audit sample for the substantive test of details with a risk of incorrect acceptance of 25 percent.

Implementing this formula in practice is quite difficult—it is not easy to precisely quantify the various levels of risks. For this reason, most CPA firms have implemented approaches that are less mathematical. However, the formula is useful in illustrating the relationships between the various types of risk. We know from the formula that in circumstances in which the auditors assess inherent risk and control risk as high and do not perform other effective tests of the assertion, the risk of incorrect acceptance must be set at a very low level. Decreases in inherent risk, control risk, or the risk that other procedures will fail to detect a material misstatement allow the auditors to set a higher risk of incorrect acceptance for the substantive test of details.

Appendix Questions

9 Ap-1. Multiple Choice Questions

- a. Which of the following are components of the risk of material misstatement?

Control Risk	Detection Risk
(1) Yes	Yes
(2) Yes	No
(3) No	Yes
(4) No	No

- b. The risk that a material misstatement could occur in an assertion assuming there are no related controls is:
 - (1) Audit risk.
 - (2) Control risk.
 - (3) Detection risk.
 - (4) Inherent risk.
- c. Performance of tests of controls where no such tests had been performed in the past is likely to:
 - (1) Increase control risk.
 - (2) Decrease control risk.
 - (3) Increase inherent risk.
 - (4) Decrease inherent risk.
- d. The auditors are establishing the allowable risk of incorrect acceptance for Substantive Procedure A. They wish to accept an audit risk of .05 and believe that other substantive procedures have a risk of .5. Furthermore:
 - Inherent risk = 1.0
 - Control risk = 1.0

Calculate the allowable risk for Substantive Procedure A. The closest reply is:

 - (1) .1
 - (2) .2
 - (3) .5
 - (4) .6
- e. An estimate of which of the following is used to calculate the allowable risk of incorrect acceptance for the substantive test in a nonstatistical sample?
 - (1) Risk of incorrect rejection.
 - (2) Projected misstatement.
 - (3) Allowable audit risk.
 - (4) Population deviation rate.

9 Ap-2. **Question Requiring Analysis**

The auditors of Wellington Electronics want to limit the risk of material misstatement in the valuation of inventories to 2 percent. They believe that there exists a 50 percent risk that a material misstatement could have bypassed the client's internal control and that the inherent risk of the account is 80 percent. They also believe that the substantive analytical procedures performed to test the assertion have a 40 percent risk of failing to detect a material misstatement.

- a. Briefly discuss what is meant by audit risk, inherent risk, control risk, and the risk that substantive analytical procedures might fail to detect a material misstatement.
- b. Calculate the maximum allowable risk of incorrect acceptance for the substantive test of details.
- c. What level of detection risk is implicit in this problem?

Cash and Financial Investments

This chapter describes the approach to the audit of cash and financial investments. Our discussion of these two types of assets is combined because of the interrelationship between them. Cash and many financial investments are liquid in nature, and transfers between the two accounts occur frequently.

Cash

Sources and Nature of Cash

LO 10-1

Describe the sources and nature of cash.

Cash normally includes general, payroll, petty cash, and, less frequently, savings accounts. General accounts are checking accounts similar in nature to those maintained by individuals. Cash sales, collections of receivables, obtaining loans, and investment of additional capital by owners typically increase the account; business expenditures decrease it. Under the terms of a bank loan agreement, the cash in a company's general account sometimes must be maintained at a specified minimum balance, referred to as a *compensating balance*.

Payroll and petty cash accounts are "imprest" at a low balance. When payroll is paid, a transfer is made from the general account to the payroll account. Petty cash, used for very small expenditures, is replenished as necessary.

Cash equivalents are often combined with cash items to create the current asset classification called "cash and cash equivalents." *Cash equivalents* include money market funds, certificates of deposit, savings certificates, and other similar types of deposits. Any item that cannot be converted to cash on short notice should be classified as an investment, a receivable, or a prepaid expense, rather than as a cash equivalent.

Normal internal control activities (e.g., reconciliation of bank accounts) detect most errors that occur in these accounts. On the other hand, the liquid nature of cash increases the risk of fraud, which may be more difficult to detect than an error.

The Auditors' Objectives in the Audit of Cash

LO 10-2

Identify the auditors' objectives in the audit of cash.

The auditors' *objectives* in the audit of cash and cash transactions are to

1. Use the understanding of the client and its environment to consider *inherent risks*, including fraud risks, related to cash.
2. Obtain an understanding of *internal control* over cash.
3. Assess the risks of material misstatement of cash and design tests of controls and substantive procedures that
 - a. Substantiate the *existence* of recorded cash and the *occurrence* of cash transactions.
 - b. Determine the accuracy of cash transactions.
 - c. Establish the *completeness* of recorded cash.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 10-1** Describe the sources and nature of cash.
- LO 10-2** Identify the auditors' objectives in the audit of cash.
- LO 10-3** Explain the nature of the cash receipts and disbursements cycles and describe the fundamental controls over the business processes related to cash.
- LO 10-4** Use the understanding of the client and its environment to consider inherent risks, including fraud risks, related to cash.
- LO 10-5** Obtain an understanding of internal control over cash.
- LO 10-6** Assess the risks of material misstatement of cash and design further audit procedures, including tests of controls and substantive procedures, to address the risks.
- LO 10-7** Describe the risks involved in auditing financial investments, including why the auditors might need specialized skills.
- LO 10-8** Identify the auditors' objectives in the audit of financial investments.
- LO 10-9** Describe typical internal controls over the business processes related to financial investments.
- LO 10-10** Describe tests of controls and substantive procedures used to audit financial investments.

- d. Verify the *cutoff* of cash transactions.
- e. Determine that the client has *rights* to recorded cash.
- f. Determine that the *presentation* and *disclosure* of cash, including restricted funds (such as compensating balances and bond sinking funds), are appropriate.

In addition to the preceding list, the auditors might add a valuation objective that relates to procedures for reconciling underlying records to the general ledger results and, if appropriate, proper valuation of foreign currency. We omit a separate valuation objective in the above list due to the ordinarily very limited valuation issues relating to cash (e.g., there is no need to consider valuation issues such as *net realizable value*, as with receivables, or the *lower of cost or market*, as with inventories).

How Much Audit Time for Cash?

The consideration of materiality applies to audit work on cash as well as to other aspects of the audit. The counting of a small petty cash fund, which is inconsequential in relation to the company's overall financial position, accomplishes little in achieving the auditors' objective of expressing an opinion on the financial statements. Nevertheless, auditors do devote a larger proportion of the total audit hours to cash than might be suggested by the relatively small amount of cash shown on the balance sheet.

Cash is often considered a **significant account** requiring additional emphasis. Several reasons exist to explain the auditors' traditional emphasis on cash transactions. Liabilities, revenue, expenses, and most other assets flow through the Cash account; that is, these items either arise from or result in cash transactions. Thus, the examination of cash transactions assists the auditors in the substantiation of many other items in the financial statements.

Another reason contributing to extensive auditing of cash is that cash is the most liquid of assets and offers the greatest temptation for theft, embezzlement, and misappropriation. Inherent risk is high for liquid assets, and auditors tend to respond to high-risk situations with more intensive investigation. However, the detection of fraud is relevant to the overall fairness of the client's financial statements only if such fraud is material in amount.

On occasion, auditors may encounter evidence of small-scale employee fraud. After determining that such fraud could *not* have a material effect upon the financial statements, the auditors should review the situation with the management and the audit committee of the board of directors before turning the matter over to client personnel for investigation. This discussion will alert the client to the situation, protect the auditors from charges of negligence, and avoid wasting audit time on matters that are not material to the financial statements and that may better be pursued by client personnel.



Internal Control over Cash Transactions

LO 10-3

Explain the nature of the cash receipts and disbursements cycles and describe the fundamental controls over the business processes related to cash.

Since cash is the most liquid of assets and overstating it can significantly improve the financial position of an organization, an effective control environment is important to its control. It is important for the organization to have a commitment to integrity and values that discourages fraudulent behavior by employees and management.

Most of the processes relating to cash handling are the responsibility of the finance department, under the direction of the treasurer. These processes include handling and depositing cash receipts; signing checks; investing idle cash; and maintaining custody of cash, marketable securities, and other negotiable assets. In addition, the finance department must forecast cash requirements and make both short-term and long-term financing arrangements.

Ideally, the functions of the finance department and the accounting department should be integrated in a manner that provides assurance that

1. All cash that should have been received *was* in fact received, recorded accurately, and deposited promptly.
2. Cash disbursements have been made for authorized purposes only and have been properly recorded.
3. Cash balances are maintained at adequate, but not excessive, levels by forecasting expected cash receipts and payments related to normal operations. The need for obtaining loans or for investing excess cash is thus made known on a timely basis.

A detailed study of the business processes of the client is necessary in developing the most efficient control procedures, but there are some general guidelines to good cash-handling practices in all types of business. These guidelines for achieving internal control over cash may be summarized as follows:

1. Separate cash handling (custody) from record keeping.
2. Centralize receiving of cash to the extent practical.
3. Record cash receipts on a timely basis.
4. Encourage customers to obtain receipts and observe cash register totals.
5. Deposit cash receipts daily.
6. Make all disbursements by check or electronic funds transfer, with the exception of possibly small expenditures from petty cash.
7. Have monthly bank reconciliations completed by employees not responsible for making cash payments or custody of cash. The completed reconciliation should be reviewed promptly by an appropriate official.
8. Monitor cash receipts and disbursements through review by management or the internal auditors. This process may be facilitated with the use of data analytics software which can identify unusual transactions and significant deviations from expected (budgeted) amounts.

Internal Control over Cash Receipts

Cash and Credit Card Sales

Control over cash sales is strongest when two or more employees (usually a salesclerk and a cashier) participate in each transaction with a customer. Restaurants and cafeterias often use a centrally located cashier who receives cash from the customer along with a sales ticket prepared by another employee. Theaters generally have a cashier selling prenumbered tickets, which are collected by a door attendant when the customer is admitted. If tickets or sales checks are serially numbered and all numbers accounted for, this separation of responsibility for the transaction is an effective means of preventing fraud.

In many retail establishments, the nature of the business is such that one employee must make over-the-counter sales, deliver the merchandise, receive cash, and record the transaction. In this situation, dishonesty may be discouraged by proper use of cash registers or electronic point-of-sale systems. The protective features of this type of technology include (1) visual display of the amount of the sale in full view of the customer; (2) a printed receipt, which the customer is urged to take with the merchandise; and (3) accumulation of the total of the day's sales.

If the establishment accepts commercial credit cards, such as Mastercard, the employee uses a terminal to process the payment through the card network and receives electronic authorization for the transaction from the credit-card-issuing bank. The transaction is eventually settled through the banking interchange and the establishment receives credit for the cash in its account. More control is established for such transactions because the employee does not have access to cash.

Electronic Point-of-Sale Systems

Many retail stores use various types of electronic point-of-sale systems. Often, an electronic scanner reads the *universal product code* on the product. The salesperson need only scan the code for the device to record the sale at the product's price, which is stored in the computer. Thus, the risk of a salesperson recording sales at erroneous prices is substantially reduced. Point-of-sale systems also have the visual display and receipt controls of a cash register.

In addition to providing strong controls over cash sales, electronic point-of-sale systems often may be programmed to perform numerous other control functions. For example, online registers may verify the credit status of charge account customers; update accounts receivable and perpetual inventory records; and provide special printouts accumulating sales data by product line, salesperson, department, and type of sale.

listing of the receipts. Internal control is strengthened by the fact that the financial institution has no access to the company's accounting records.

Proceeds from credit card and debit card sales are handled in a similar manner by the bank(s) involved with the process. Ultimately, proceeds are deposited into the business's cash account.

Electronic Funds Transfer

Electronic funds transfer (EFT) systems process funds-related transactions for customers as an alternative to paying by check. Increasingly, **electronic data interchange (EDI)** systems, which allow the interchange of data from one company's computer to another's, are electronically transferring funds between companies' bank accounts. These systems reduce paper flow and may reduce processing costs and delays. They do, however, require an extensive set of computer network controls relating to system access and data entry, as well as backup controls for situations in which a system breakdown occurs.

Recording Cash Receipts

The employee responsible for the customers' accounts ledger enters the details of cash receipts into the computer in batches. The cash receipts program creates a digital file of cash receipt transactions that is used to update the general ledger and the master file of accounts receivable. This computer program creates control totals and exception reports that detail any invalid customer account numbers or unusual payment amounts. The manual follow-up procedures on exceptions reports and the reconciliations of control totals are performed by the operations control group.

The division of responsibilities, sequence of procedures, and controls over cash sales and collections from customers are illustrated in the systems flowchart in Figure 10.1.

Internal Control over Cash Disbursements

Ideally, cash disbursements should be made by check, by electronic funds transfer, or, for minor items, from petty cash funds.

Checking Account Disbursements

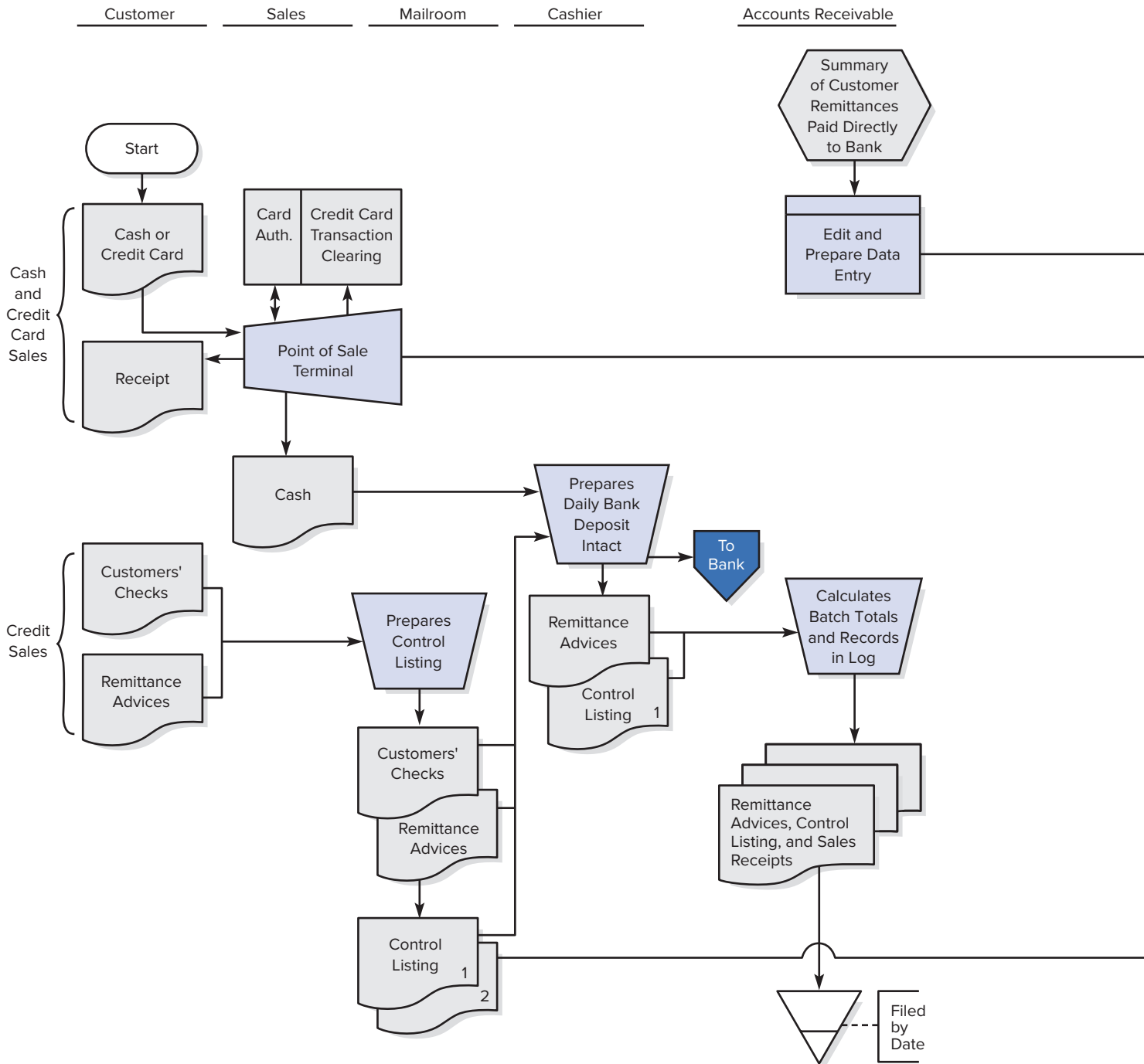
A principal advantage of requiring disbursement by check is obtaining evidence of receipt from the payee in the form of an endorsement on the check. Other advantages include (1) the centralization of disbursement authority in the hands of a few designated officials—only persons authorized to sign checks; (2) a permanent record of disbursements; and (3) a reduction in the amount of cash kept on hand.

To secure in full the internal control benefits implicit in the use of checks, it is essential that all checks be prenumbered and all numbers in the series be accounted for. Unissued prenumbered checks should be adequately safeguarded against theft or misuse. **Voided checks** should be defaced to eliminate any possibility of further use and filed in the regular sequence of paid checks. Dollar amounts should be printed on all checks by the computer or a check-protecting machine. This practice makes it difficult for anyone to alter a check by raising its amount.

Officials authorized to sign checks should review the documents supporting the payment and perforate (deface) these documents at the time of signing the check to prevent them from being submitted a second time. The official signing checks should maintain control of the checks until they are placed in the mail. Typically, the check comes to the official complete except for signature. To make a variety of fraudulent schemes involving falsified documents less likely, the signed checks should not be returned to the accounting department, which prepared them for signature.

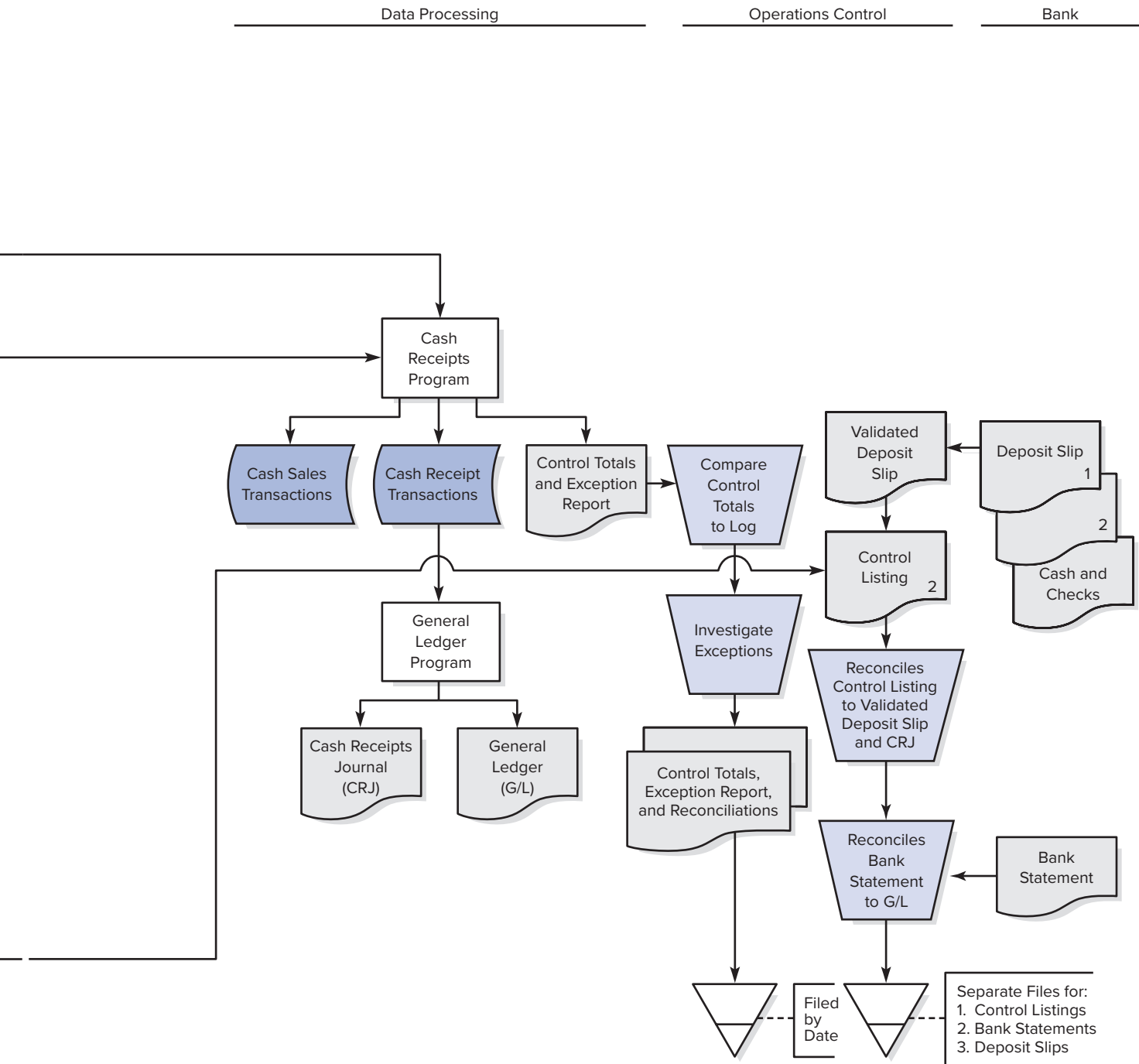
Companies that issue large numbers of checks use computerized systems to process disbursements. Invoices and supporting documents are stored in the system and disbursements are authorized and approved online. The computer generates negotiable checks or electronic transfers are used to transfer funds to vendors' accounts.

Reconciliation of monthly bank statements is essential to adequate internal control over cash receipts and disbursements. An employee having no part in authorizing or

FIGURE 10.1 Cash Receipts Cycle

accounting for cash transactions or in handling cash should reconcile bank statements. If statements are received from the bank, they should come unopened to this employee. Each month the completed bank reconciliation should be reviewed and approved by a responsible company official.

A voucher system is one method of achieving strong internal control over cash disbursements by providing assurance that all disbursements are properly authorized and reviewed before a check is issued. In a typical voucher system, the accounting department is responsible for assembling the appropriate documentation to support every cash disbursement. For example, before authorizing payment for merchandise purchased, the accounting department assembles copies of the purchase order, receiving report, and



vendor's invoice and determines that these documents are in agreement. After determining that the transaction is properly supported, an accounting employee prepares a voucher, which is filed by date due.

A **voucher** system, in this usage, is a system that conveys vouchers through the performance and authorization functions. Authorization functions include such procedures as extending and footing the vendor's invoice; determining the agreement of the invoice, purchase order, and receiving report; and recording the transaction in the accounts. Transactions are recorded in a **voucher register** (which normally replaces a purchases journal) by an entry debiting the appropriate asset, liability, or expense account and crediting Vouchers Payable. The separation of the function of invoice verification and approval from the



Illustrative Case

Importance of Cash Controls

Rita Crundwell, the treasurer and controller of the city of Dixon, Illinois, perpetrated a \$53.7 million fraud over 22 years. The fraud was accomplished through a “secret bank account” open by Crundwell in the name of the Reserve Sewer Capital Development Account. Crundwell created phony invoices for city improvements, writing checks in payment from one of the City’s bank accounts and payable to the “Treasurer.” She would then deposit the checks into the secret account, using the funds from that account to pay her personal expenditures.

This fraud shows the problem of having a lack of segregation of duties over cash disbursements. Crundwell reconciled

the bank accounts, made deposits, and was provided sole access to all statements and correspondence from Dixon’s bank. Another red flag in this case was the lavish lifestyle that Crundwell enjoyed. Crundwell owned several residences and a number expensive vehicles, and she poured millions of dollars into her quarter horse breeding business.

In this circumstance, the City and its auditors should have examined carefully the City’s expenditures. The fraud might have been detected by analytics focused on the reasonableness of the amounts of improvement expenditures.

function of cash disbursement is another step that tends to prevent errors and fraud. On the payment date, the voucher and supporting documents are removed from the tickler file and the check is prepared *but not signed*. The voucher, supporting papers, and the check (complete except for signature) are forwarded to the finance department for signature.

In a computerized purchasing system, vendor invoice information will be entered by the accounting (accounts payable) department and it may be matched by the computer with purchase order and receiving information that was entered by the other departments. If the information matches, the computer will approve the payment and automatically record the voucher as a payable. Transactions with inconsistencies will not be processed, but will be listed on an exception report for review and follow-up by the operations control group. To prevent duplicate payments of the same invoice, the company should be assured that it does business with vendors that use an appropriate unique invoice numbering system, and the accounts payable department implements procedures to assure that vendor names, numbers, and invoice numbers are accurately inputted. Just prior to the invoice’s due date, the computer will generate a check or an electronic funds transfer in payment of the invoice. If checks are signed by the computer, they need not be sent to the vouchers payable department for mailing. As a further control, the computer software should be designed to identify unusual disbursements for review.

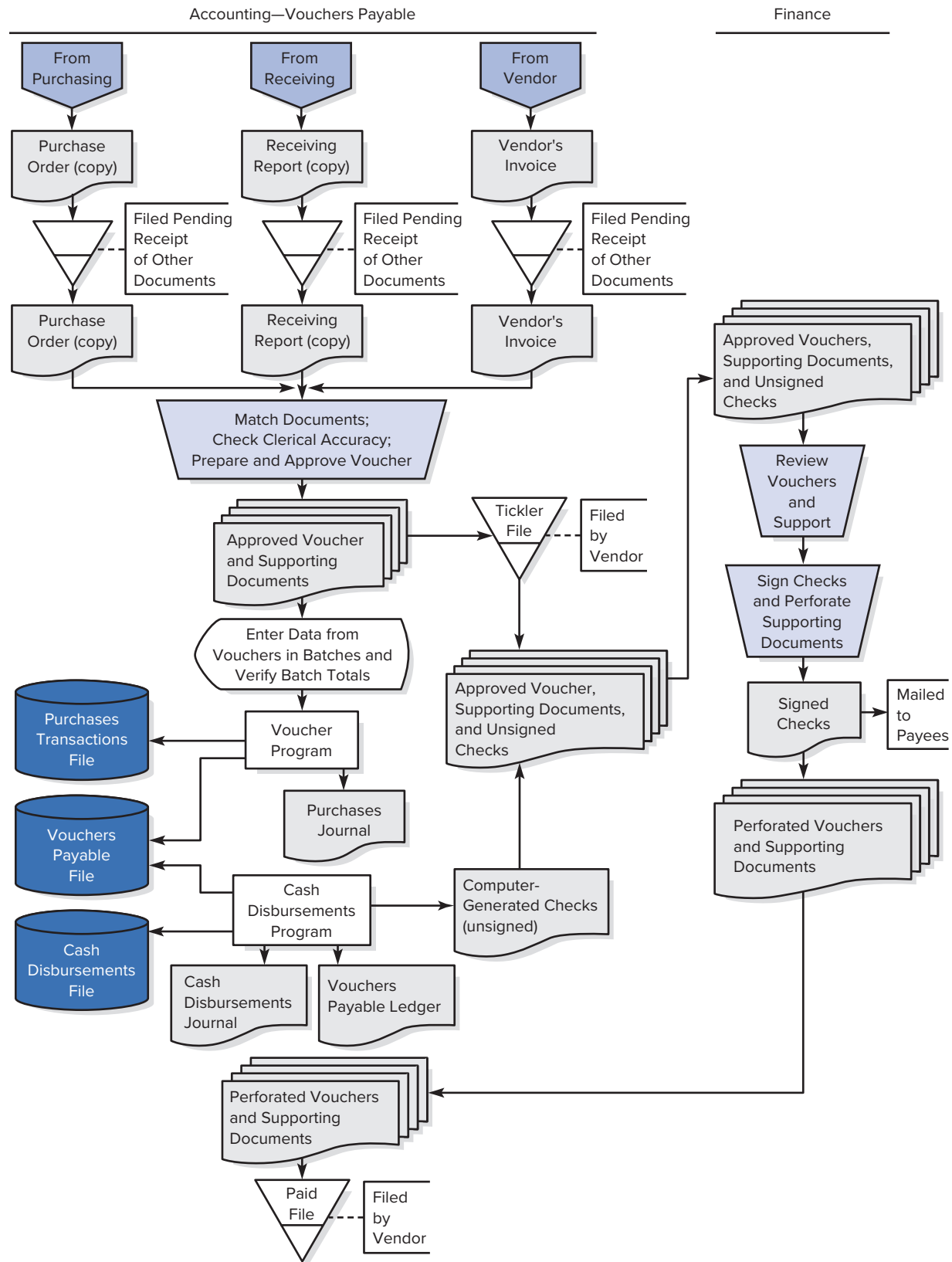
Another control the auditors may expect to find in a well-managed accounts payable department is the monthly balancing of the detailed records of accounts payable (or vouchers) to the general ledger control account. These reconciliations are saved as evidence of the performance of this procedure and as an aid in locating any subsequent errors or fraud.

Vendors’ statements, received monthly, should be reconciled promptly with the accounts payable ledger or list of open vouchers, and any discrepancies should be fully investigated. In some industries, it is common practice to make advances to vendors, which are recovered by making percentage deductions from invoices. When advances are made, the auditors should ascertain that procedures are being followed to ensure that deductions from the invoices are being made in accordance with the terms of the agreement.

The operation of a voucher system is illustrated in the flowchart in Figure 10.2.

Internal Control over Employee Reimbursements

When employees incur business expenses on behalf of the company, the company must establish effective controls over employee reimbursements. Many companies require employees to submit expense reports with receipts and explanations for their expenditures. The reports are typically approved by the employee’s supervisor and submitted to the accounting department for processing. This documentation is used to support the reimbursement through the company’s normal payment system. Employees are often reimbursed through direct deposit to their bank accounts.

FIGURE 10.2 Flowchart of a Cash Disbursements Cycle (Voucher System)*

*This flowchart presents disbursements by check. Disbursements by credit card, debit card, and electronic transfer are similar, with the check being replaced by documentation relating to the particular type of disbursement. The cash receipts discussion in this chapter discusses these alternate forms of cash receipts.

Some companies issue business credit cards to employees that incur significant amounts of expenses on behalf of the company. Employees are usually required to document explanations for their credit card expenditures, often including credit card receipts.

Regardless of the controls over processing employee expenses, management may also develop automated management review controls to identify potential excessive or fraudulent expenditures.

Internal Control Aspects of Petty Cash Funds

Internal control over payments from an imprest petty cash fund is achieved when the custodian of the petty cash fund reviews support from employees seeking reimbursement for their small expenditures on behalf of the company. Further control exists when the custodian requests replenishment of the fund and another individual reviews the support for completeness and authenticity and subsequently defaces that support to prevent reuse. Finally, a check is issued to the custodian in the amount of the substantiated expenditures to replenish the fund.

Petty cash funds are never material to the company's financial statements. Therefore the auditors' focus is on the transactions rather than the year-end balance. The auditors may review the amount of the reimbursements over the period or test one or more of the replenishment transactions by examining the supporting documentation.

Petty cash funds are becoming much less common as companies move to the use of Purchasing Cards (P-Cards) or ProCards (Procurement Cards). These cards are essentially company credit cards that may be used by a designated employee for business expenses. The cards have spending limits and the company typically requires employees to substantiate expenditures with receipts.

Monitoring Cash Transactions

It is important for management to monitor cash receipts and disbursements to achieve effective internal control. **Management review controls** are key to identifying cash receipts and disbursements that potentially may be misstated. As an example, management may perform periodic reviews of cash journal and ledgers for unusual transactions or entries. In an IT system, management reviews may be performed with **data analytics** software. The software may be used to continuously monitor all cash transactions for those that may be erroneous, fraudulent, or otherwise unusual. Management can then investigate the items identified by the software. Management review controls are also useful at identifying situations in which other controls have failed.

Audit Documentation for Cash

Auditors' working papers for cash typically include a flowchart or a written description of controls. An internal control questionnaire is also often used, especially in larger companies. A related working paper will summarize tests of controls for cash transactions and the assessments of risk for the financial statement assertions about cash.

Additional cash working papers include documentation of risk assessments, an audit plan, a lead schedule, cash count sheets, bank confirmations, bank reconciliations, inter-bank transfer schedules, lists of outstanding checks, lists of checks being investigated, recommendations to the client for improving internal control, and notes concerning proper presentation and disclosure of cash in the client's balance sheet.

Audit of Cash

The following steps indicate the general pattern of work performed by the auditors in the audit of cash. Selection of the most appropriate procedures for a particular audit will be guided by the nature of the controls that have been implemented and by the results of the auditors' risk assessment process.

- A. Use the understanding of the client and its environment to consider inherent risks, including fraud risks, related to cash.
- B. Obtain an understanding of internal control over cash.

- C. Assess the risks of material misstatement and design further audit procedures.
- D. Perform further audit procedures—tests of controls.
 - 1. Examples of tests of controls:
 - a. Test controls over the accuracy and completeness of accounting records and bank reconciliations.
 - b. Test controls over the accuracy and completeness of processing cash receipts and recording them in the accounting records.
 - c. Test controls over the accuracy and completeness of cash disbursements and recording them in the accounting records.
 - d. Test management review controls.
 - 2. If necessary, revise the risk of material misstatement based on the results of tests of controls.
- E. Perform further audit procedures—substantive procedures for cash transactions and balances.
 - 1. Obtain analyses of cash balances and reconcile them to the general ledger.
 - 2. Confirm cash balances with financial institutions.
 - 3. Obtain or prepare reconciliations of bank (financial institution) accounts as of the balance sheet date and consider the need to reconcile bank activity for additional months.
 - 4. Obtain a cutoff bank statement containing transactions of at least seven business days subsequent to the balance sheet date.
 - 5. Identify and investigate unusual cash receipts and disbursements.
 - 6. Count and list cash on hand.
 - 7. Verify the client's cutoff of cash receipts and cash disbursements.
 - 8. Analyze bank transfers for the last week of the audit year and the first week of the following year.
 - 9. Investigate payments to related parties.
 - 10. Evaluate proper financial statement presentation and disclosure of cash.

Figure 10.3 relates these substantive procedures to the primary audit objectives.

LO 10-4

Use the understanding of the client and its environment to consider inherent risks, including fraud risks, related to cash.

A. Use the Understanding of the Client and Its Environment to Consider Inherent Risks, Including Fraud Risks, Related to Cash.

Risks of material misstatement at the assertion level arise jointly from inherent risk and control risk. Most inherent risks relate to business risks faced by the client's management. In the area of cash and financial investments, management is particularly concerned with

FIGURE 10.3
Objectives of Major
Substantive Procedures
for Cash Transactions
and Balances

Substantive Procedures	Primary Audit Objectives
Obtain analyses of cash balances and reconcile them to general ledger.	<i>Existence and accuracy</i>
Confirm cash balances with financial institutions. Obtain reconciliations of bank balances and consider reconciling bank activity. Obtain bank cutoff statement. Identify and investigate unusual cash receipts and disbursements. Count cash on hand.	<i>Existence, occurrence, accuracy, cutoff, and rights</i>
Verify the client's cutoff of cash transactions.	<i>Cutoff</i>
Analyze bank transfers occurring around year-end.	<i>Existence, occurrence, accuracy, cutoff, and rights</i>
Investigate payments to related parties. Evaluate financial statement presentation and disclosure.	<i>Presentation and disclosure</i>



business risks related to the possible theft of these liquid assets. This is also a significant concern of the auditors as most misstatements of assets involve overstatement.

In addition to concerns about the overstatement of cash, auditors are aware that cash may have been improperly abstracted during the period, even though the year-end cash may be properly stated. To distinguish between the situations, assume that the client's balance sheet shows "Cash \$250,000." For most clients, the primary risks are that errors or fraud create a situation in which either (1) \$250,000 overstates actual cash or (2) the \$250,000 recorded year-end balance should be higher.

Concerning the first risk (overstated cash), a shortage may have been concealed merely by the insertion of a fictitious check from a third party in the cash on hand at year-end, or by the omission of an outstanding check from the year-end bank reconciliation. Note that the omission of an outstanding check may be indicative of either an error or fraud. For example, poor internal control may result in a situation in which human error resulted in the check not being recorded in disbursements. On the other hand, although recorded in cash disbursements, the check may have been omitted from the outstanding check list to allow the individual who has embezzled that amount of cash to hide fraud.

Concerning the second risk—the year-end cash is correct, but should be higher—the auditors' problem is not misstated cash, but fraud and its effect on other accounts. Consequently, the auditors have in mind such basic questions as (1) Do the client's records reflect all cash transactions that took place during the year? and (2) Were all cash payments properly authorized and for a legitimate business purpose? Examples of fraud that may be disclosed in searching for answers to these questions are

1. Interception of cash receipts before any record is made.
2. Payment for materials not received.
3. Duplicate payments.
4. Overpayments to employees or payments to fictitious employees.
5. Payments for personal expenditures of officers or related parties.

Based on their knowledge of the client and its environment, the auditors may identify other business risks that result in risks of material misstatements. In some engagements, the auditors may be particularly concerned with the risk of the completeness of recorded cash. As an example, management of a privately held company may be motivated to understate assets (e.g., not record cash sales transactions) to minimize income taxes. Also, for a particular client, there may be a risk that management maintains bank accounts not recorded on the books for such purposes as making illegal bribes. Thus, in such situations, there is a heightened risk that not all cash may be recorded in the financial records. In other cases, the manner in which the client collects cash may present significant business and inherent risks. For example, a charitable organization may receive a large amount of funds from cash donations, creating a significant inherent risk that not all cash donations may be received and recorded.

The auditors also may identify fraud risks related to cash transactions. In such cases, the auditors should obtain an understanding of the controls used by management to mitigate these risks and determine whether the controls have been implemented. Strengths and weaknesses in the client's internal control serve to mitigate or increase the effects of these fraud risks.

LO 10-5

Obtain an understanding of internal control over cash.

B. Obtain an Understanding of Internal Control over Cash.

In the audit of a small business, the auditors may prepare a written description of controls, based upon the questioning of owners and employees and upon firsthand observation. For larger companies, a flowchart or internal control questionnaire is usually employed to describe internal control. An internal control questionnaire for cash receipts was illustrated in Chapter 7. Among the questions included in a questionnaire for cash disbursements are whether all disbursements (except those from petty cash) are made by prenumbered checks and whether voided checks are marked "void" and

saved. The existence of these controls permits the auditors to determine that all disbursements have been recorded by accounting for the sequence of checks issued or voided during the period.

Other points to be made clear by the questionnaire include (1) whether check-signing authority (electronic or manual) is restricted to selected executives not having access to accounting records or to vouchers and other documents supporting checks submitted for signature and (2) whether checks are sent directly to the payees after being signed. The internal control questionnaire also will cover cash disbursements for payroll and for dividends, as well as bank reconciliation procedures.

After the auditors have prepared a flowchart (or other description) of internal control, they will conduct a walk-through of the system. The term *walk-through* means to trace a transaction or a few transactions through each step of the system to determine that transactions actually are being processed in the manner indicated by the flowchart. The walk-through allows the auditors to determine that internal control as described in the working papers has actually been implemented.

As the auditors verify their understanding of the cash receipts and disbursements cycles, they will observe whether there is appropriate segregation of duties and inquire about who performed various functions throughout the year. They also will inspect the various documents and reconciliations that are important to the client's internal control over cash receipts and disbursements. Cash forecasts or budgets also will be inspected and the auditors will review the evidence of the follow-up on variances from forecasted amounts of receipts and disbursements. In some cases, the auditors will review exception reports generated by the computer and the evidence of the follow-up on them. These tests of controls provide the auditors with evidence to support their assessed level of control risk.

LO 10-6

Assess the risks of material misstatement of cash and design further audit procedures, including tests of controls and substantive procedures, to address the risks.

C. Assess the Risks of Material Misstatement and Design Further Audit Procedures.

After considering the information about the client and its environment, including internal control over cash receipts and disbursements, the auditors identify and assess the **risks of material misstatement** at the financial statement and assertion levels. At the financial statement level, they assess whether identified risks have (1) a pervasive effect on the financial statements and require an overall response and (2) effects on individual financial statement assertions. At the assertion level, the auditors identify **relevant assertions** and design appropriate further audit procedures (tests of controls and substantive procedures) in response. If additional evidence of effectiveness of the controls is needed to support these assessed levels, the auditors will design additional tests of control. In designing these tests, the auditors must decide which ones will result in sufficient reductions in substantive procedures to justify the time spent performing them. This entire process is described in detail in Chapter 6.

By considering these risk assessments, the auditors are able to identify “what could go wrong” to cause the cash accounts to be materially misstated. Figures 10.4 and 10.5 provide examples of possible material misstatements of cash that may be identified by the auditors based on the client's operations and environment, and on weaknesses in its internal control over cash receipts and cash disbursements. Once these risks of material misstatement have been identified and assessed, the auditors can plan appropriate substantive procedures that address them.



D. Perform Further Audit Procedures—Tests of Controls.

1. Examples of Tests of Controls.

Tests directed toward the effectiveness of controls help to evaluate the client's internal control and determine whether the auditors' planned assessed levels of the risks of material misstatement can be supported. Certain tests of controls are performed as the auditors obtain an understanding of the client's internal control; these tests were described in our discussion of that process. The following are examples of typical further tests of controls.

FIGURE 10.4 Potential Misstatements—Cash Receipts

Description of Misstatement	Examples	Internal Control Weaknesses or Factors That Increase the Risk of the Misstatement
Recording fictitious cash receipts	Fraud: Overstating cash receipts on the books by transferring cash between bank accounts without appropriate recording of the transfer to cover up an embezzlement of cash	Lack of segregation of duties of the functions of access to cash and record keeping; no effective review of bank reconciliations
Failure to record receipts from cash sales	Fraud: - A cashier fails to ring up and record cash sales and embezzles the cash Error: - A bookkeeper accidentally omits the recording of the receipts from one cash register for the day	- Inadequate supervision of cashiers; failure to encourage customers to obtain cash receipts - Inadequate controls for reconciling cash register tapes and accounting records; inadequate controls for reconciling bank accounts
Failure to record cash from collection of accounts receivable	Fraud: - A cashier embezzles cash payments by customers on receivables, without recording the receipts in the customers' accounts - A bookkeeper who has access to cash receipts embezzles cash collected from customers and writes off the related receivables Error: - A bookkeeper accidentally fails to record payment on a receivable	- Lack of segregation of duties between personnel who have access to cash receipts and those who make entries into the accounts receivable records - Lack of proper authorization of write-offs and lack of segregation of duties between personnel who have access to cash receipts and those who make entries into the accounts receivable records - Inadequate reconciliations of subsidiary records of accounts receivable with the general ledger control account
Early (late) recognition of cash receipts—"cutoff problems"	Fraud: - Holding the cash receipts journal open to record next year's cash receipts as having occurred in this year Error: - Recording cash receipts based on bad information about date of receipt	- Ineffective board of directors, audit committee, or internal audit function; "tone at the top" not conducive to ethical conduct; undue pressure to show improved financial position - Failure to list and deposit cash receipts on a timely basis

a. Test controls over the accuracy and completeness of accounting records and bank reconciliations.

To determine that the client's accounting procedures are operating effectively, the auditors perform tests of the accuracy of the client's journals and ledgers. In a computer-based system, journal and ledger entries may be created simultaneously from the same source documents, and the auditors might choose to use automated tools and techniques to test the accuracy of the accounting records.

In a manual system, information on source documents is entered first in a journal; at a later date, the information is summarized and posted from journals to ledgers. The auditors must manually determine that the documents are accurately entered to the journals, the journals are accurately footed, and the data are properly posted to the ledgers. The auditors also may decide to test the client's procedures for reconciling bank (financial institution) accounts. They may select a sample of the reconciliations performed during the year, noting who performed them, and *reperform* the reconciliation process by reference to accounting records, bank statements, and **canceled checks**.

FIGURE 10.5 Potential Misstatements—Cash Disbursements

Description of Misstatement	Examples	Internal Control Weaknesses or Factors That Increase the Risk of the Misstatement
Inaccurate recording of a purchase or disbursement	Fraud: A bookkeeper prepares a check to himself and records it as having been issued to a major supplier	Inadequate segregation of duties of record keeping and preparing cash disbursements, or check signer does not review and cancel supporting documents
	Errors: - A disbursement is made to pay an invoice for goods that have not been received - Disbursements for travel and entertainment are improperly included with merchandise purchases	- Ineffective controls for matching invoices with receiving documents before disbursements are authorized - Ineffective accounting coding procedures may result from incompetent accounting personnel, inadequate chart of accounts, or no controls over the posting process
Duplicate recording and payment of purchases	Error: A purchase is recorded when an invoice is received from a vendor and recorded again when a duplicate invoice is sent by the vendor	Ineffective controls over the input of invoices that allow invoices from the same vendor with the same invoice number to be processed more than once
Unrecorded disbursements	Fraud: In conjunction with unrecorded (but deposited) cash receipts, an employee writes and cashes an unrecorded check for the identical amount	Ineffective control over record keeping for and access to cash

b. Test controls over the accuracy and completeness of processing cash receipts and recording them in the accounting records.

Satisfactory internal control over cash receipts demands that each day's collections be deposited intact (in its entirety) no later than the next banking day. To provide assurance that cash receipts have been deposited intact, the auditors may compare the detail of the original cash receipts listings (mailroom listings and register tapes) to the detail of the daily deposit tickets. The *detail* of cash receipts refers to a listing of the amount of each individual check and the total amount of currency composing the day's receipts.

Comparison of the details of the daily entries in the cash receipts journal and accounts receivable subsidiary ledger with bank deposits may disclose a type of fraud known as *lapping*. Lapping is the concealment of a cash shortage by delaying the recording of cash receipts. The table below provides an illustration.

If cash collected from customer A is withheld by the cashier, a subsequent collection from customer B may be entered as a credit to A's account. B's account will not be shown as paid until a collection from customer C is recorded as a credit to B. Unless the money abstracted by the cashier is replaced, the accounts receivable as a group remain overstated;

Date	Actually Received from	Actual Cash Receipts	Recorded as Received from	Receipts Recorded and Deposited	Receipts Withheld
Dec. 1	Abbott	\$ 750			\$ 750
	Crane	1,035	Crane	\$1,035	
2	Barstow	750	Abbott	750	
	White	130	White	130	
3	Crawford	1,575	Barstow	750	
	Miller	400	Miller	400	825
		<u>\$4,640</u>		<u>\$3,065</u>	<u>\$1,575</u>

but judicious shifting of the overstatement from one account receivable to another may avert protests from customers receiving monthly statements. The schedule above makes clear how a lapping activity may be carried on. In companies in which the cashier has access to the general accounting records, shortages created in this manner have sometimes been transferred to inventory accounts or elsewhere in the records for temporary concealment.

Lapping is most easily carried on when an employee who receives collections from customers is responsible for the posting of customers' accounts. Familiarity with customers' accounts makes it relatively easy to lodge a shortage in an account that will not be currently questioned. The auditors may detect such an ongoing scheme by comparing the details of the bank deposit slips with receipts recorded in the accounting records. For example, notice that on December 2 in the illustration above, the bank deposit slip will include a \$750 check from Barstow, while the accounting records will indicate that the payment was from Abbott.

If the company has implemented a lockbox system with its financial institution, there may be no need to perform this procedure as the client's staff have no access to cash receipts. In an IT system, comparisons of details of cash receipts entries with entries into customer accounts may be performed with computer-assisted audit techniques (CAATs).

c. Test controls over the accuracy and completeness of cash disbursements and recording them in the accounting records.

Satisfactory internal control over cash disbursements requires that controls exist to provide assurance that disbursements are properly authorized. Testing cash disbursements may involve tracing selected items back through the cash disbursements journal to original source documents, including vouchers, purchase orders, receiving reports, invoices, and paid checks. While examining these documents, the auditors have an opportunity to test many of the controls over cash disbursements. For example, they will notice whether all hard-copy paid vouchers and supporting documents have been perforated or canceled. Also, they will determine whether agreement exists among the supporting documents and note the presence of all required authorization signatures. The auditors also may review the file of paid checks to test the client's procedures for accounting for the numerical sequence of checks.

In a well-controlled IT system many of the tests of the controls over disbursements may be performed using data analytics. The auditors may determine that 100 percent of disbursements during the period have been approved and are supported with appropriate electronic documents. If they find a lack of compliance with controls over particular types of disbursements, they may use data analytics techniques that focus upon those disbursements to identify transactions that might be unauthorized or misstated.

d. Test management review controls.

Management review controls, if effectively designed and implemented, can be instrumental in identifying misstatements or other issues related to cash receipts and disbursements. The auditors will evaluate the design effectiveness of the controls by considering the relevance and precision of the controls. The controls may be effective if they address relevant financial statement assertions and are sufficiently precise to identify material misstatements. Their precision is affected by the level of aggregation of the data, the consistency of their performance, the reliability (predictability) of management expectations, and the criteria used to determine when items are investigated. If the design of these controls is considered to be effective, the auditors may test the controls by inspecting a sample of documentation of performance of the controls, including the manner in which unusual items or relationships were identified, investigated, and resolved. The auditors may also decide to reperform management's review on a test basis.

2. If Necessary, Revise the Risk of Material Misstatement Based on the Results of Tests of Controls.

When the auditors have completed the procedures described in the preceding sections, they should reassess the level of control risk for each financial statement assertion regarding cash. The auditors then decide what modifications, if any, are necessary to the planned substantive procedures for cash transactions and balances.



Illustrative Case

Electronic Confirmation of Cash and Loans

Capital Confirmation Inc. (Confirmation.com), recently acquired by Thomson Reuters Corp., provides an electronic service for CPAs and financial institutions. This service represents the implementation of a “business plan” developed by Brian Fox, CPA, as a part of an assignment in a master’s level course.

While working as a CPA, Brian Fox identified certain inefficiencies and potential for fraud inherent in the written confirmation process. His vision for a solution, which has similarities to the “PayPal” model, was to develop a secure clearing-house in which both CPAs and financial institutions could be assured that not only was the confirmation transmission

process itself secure, but also that the proper authorized individuals were responding.

Confirmation.com offers both in-network and out-of-network electronic confirmations. When an audit team begins its fieldwork, they request confirmations electronically through Confirmation.com, which then allows the appropriate individuals at the banks to respond to the requests through the network. While the paper confirmation process ordinarily takes several weeks (at a minimum), electronic confirmation responses are often received within a day. Currently, most large banks and thousands of CPAs use the in-network services of Confirmation.com. Confirmation.com’s out-of-network service allows electronic confirmations to be sent to banks outside of the network.

E. Perform Further Audit Procedures—Substantive Procedures for Cash Transactions and Balances.

1. Obtain Analyses of Cash Balances and Reconcile Them to the General Ledger.

The auditors will prepare or obtain a schedule that lists all of the client’s cash accounts. For cash in bank accounts, this schedule will typically list the bank, the account number, the account type, and the year-end balance per books. The auditors will trace and reconcile all accounts to the general ledger.

2. Confirm Cash Balances with Financial Institutions.

One of the objectives of the auditors’ work on cash is to substantiate the existence of the amount of cash shown on the balance sheet. A direct approach to this objective is to confirm amounts on deposit and obtain or prepare reconciliations between bank statements and the accounting records.

Confirmation of amounts on deposit by direct communication with financial institution officials is generally obtained in audits, particularly when a relatively high risk of material misstatement exists.¹

Account balances held by financial institutions are often confirmed with a standard form, as illustrated by Figure 10.6. This **standard confirmation form**, agreed to by the AICPA, the American Bankers Association, and the Bank Administration Institute, addresses *only* the client’s deposit and loan balances. Information identifying accounts and loans and their balances is normally included on the form to assist the financial institution in completing it. Thus, the form is primarily used to *corroborate* the existence of recorded information. However, the confirmation also may lead to the *discovery* of additional accounts or loans and, therefore, it provides limited evidence about the *completeness* of recorded amounts. Although the personnel at the financial institution will not conduct a detailed search of the records, they will include information about additional deposits and loans that they note while completing the confirmation.

Auditors must carefully consider any restrictions included as a part of confirmation responses; this applies to both cash and other accounts confirmed (e.g., receivables). AU-C 505 provides examples of restrictions, including

- Information is furnished as a matter of courtesy without a duty to do so and without responsibility, liability, or warranty, express or implied.

¹ PCAOB standards (PCAOB AS 2310) address the situation in which client cash (and cash equivalents) are held by third parties other than financial institutions. If feasible, when relevant assertions are involved, the auditors should perform confirmation procedures or otherwise obtain relevant and reliable audit evidence by directly accessing information maintained by a knowledgeable external source.

Primary Audit Objectives:	
Existence	☒
Accuracy	☒
Cutoff	☒

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Accuracy	☒
Cutoff	☒
Rights	☒

FIGURE 10.6 Confirmation Form

**STANDARD FORM TO CONFIRM ACCOUNT
BALANCE INFORMATION WITH FINANCIAL INSTITUTIONS**

ORIGINAL
To be mailed to accountant

The Fairview Corporation
CUSTOMER NAME

We have provided to our accountants the following information as of

the close of business on December 31, 20 , X3
regarding our deposit and loan balances. Please confirm the accuracy of the information, noting any exceptions to the information provided. If the balances have been left blank, please complete this form by furnishing the balance in the appropriate space below. *Although we do not request or expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other deposit and loan accounts we may have with you comes to your attention, please include such information below. Please use the enclosed envelope to return the form directly to our accountants.

Financial Institution's Name and Address

Security National Bank
1000 Wilshire Boulevard
Los Angeles, California 90017-3562

1. At the close of business on the date listed above, our records indicated the following deposit balance(s):

ACCOUNT NAME	ACCOUNT NO.	INTEREST RATE	BALANCE*
General Account	133-7825	None	\$89,548.92
Payroll Account	133-8765	None	8,212.05

2. We were directly liable to the financial institution for loans at the close of business on the date listed above as follows:

ACCOUNT NO./ DESCRIPTION	BALANCE*	DATE DUE	INTEREST RATE	DATE THROUGH WHICH INTEREST IS PAID	DESCRIPTION OF COLLATERAL
55-8965T	\$324,877	6/15/X7	12 ¹ / ₂ %	12/15/X3	Furniture & Fixtures
Credit Line	\$200,000	3/31/X4	13 ¹ / ₄ %	12/31/X3	Unsecured

Judith Fareri
(Customer's Authorized Signature)

January 16, 20X4
(Date)

The information presented above by the customer is in agreement with our records. Although we have not conducted a comprehensive, detailed search of our records, no other deposit or loan accounts have come to our attention except as noted below.

Jeanne M. Mebus
(Financial Institution Authorized Signature)

Audit Inquiry Clerk
(Title)

January 31, 20X4
(Date)

EXCEPTIONS AND/OR COMMENTS

Please return this form directly to our accountants:

*Ordinarily, balances are intentionally left blank if they are not available at the time the form is prepared.

Douglas & Troon, CPAs
800 Hill Street
Los Angeles, CA 90014-7865

Approved 1990 by American Bankers Association, American Institute of Certified Public Accountants, and Bank Administration Institute. Additional forms available from: AICPA – Order Department, P.O. Box 1003, NY, NY 10108 – 1003

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- The response is given solely for the purpose of the audit without any responsibility on the part of the respondent, its employees, or its agents, and it does not relieve the auditors from any other inquiry or the performance of any other duty.
- Information is obtained from electronic data sources, which may not contain all information in the respondent's possession.
- Information is not guaranteed to be accurate or current and may be a matter of opinion.
- The recipient may not rely upon the information in the confirmation.



Illustrative Case

Controlling Confirmation Requests

The need to control the confirmation process is illustrated in the Parmalat fraud case. In that case, an *SEC Litigation Release* reports that the auditors received a bank confirmation confirming that a subsidiary of Parmalat held the equivalent of \$4.8 billion (denominated in euros) in cash and marketable securities in a Bank of America account in New York City. The bank account and marketable securities did not exist.

It is believed that the auditors used Parmalat's internal mail to request financial information, and the confirmation was intercepted by a member of management. According to *The Wall Street Journal*, prosecutors believed that the reply information on the fraudulent confirmation was created in Parmalat's main offices by scanning Bank of America's logo into a computer, printing it out, and then passing the sheet of paper several times through a fax machine to make it look more authentic.

The standard suggests that while the first two examples may not affect the reliability of the response, the final three may cast doubt about the completeness or accuracy of the confirmed information. When such a restriction occurs, clarification of it with the respondent or seeking legal advice may be appropriate in such situations. If doubts remain, consideration of additional procedures becomes necessary. For example, the PCAOB (AS 2310) suggests that it may be possible to verify information by viewing the information directly on a secure website of the financial institution.

Frequently the confirmation process with financial institutions is performed electronically. Benefits of an electronic approach may include higher response rates, quicker turnaround times, and ease of confirmation to the bank. As indicated in the *Illustrative Case: Electronic Confirmation of Cash and Loans* above, auditors often use an electronic clearing house approach, which involves a service provider such as Capital Confirmation, Inc. Such a service provider often initiates the confirmation request, establishes contact with the bank (or other organization as appropriate), obtains confirmation of the requested information, and provides it to the auditors. In such a situation, the auditor will consider the design and operating effectiveness of the service provider's processes and controls, often through obtaining a **System and Organization Controls (SOC) Report**, which the provider has had its CPAs perform. SOC reports are discussed in Chapters 7 and 20.

Rather than CPAs using a service provider, the personnel at the financial institution may directly provide the auditors (with client authorization) access to a secure website that contains the requested information. In such situations, if the needed financial institution website information was obtained only from client personnel, auditors should perform procedures to assure the validity of the website and information obtained as in these situations there is a risk that the client personnel may create a fictitious website or account to misstate the information being confirmed.

The details of other financial arrangements may be confirmed with financial institutions, using separate confirmation letters sent to the individual at the financial institution who is responsible for the client's financial arrangements or is knowledgeable about those arrangements. For example, the auditors may send a separate confirmation form to corroborate compensating balance arrangements or authorized check signers. These confirmation forms are described in detail in Chapter 15.

Finally, although the confirmation of cash is a very frequently performed procedure, when the risk of material misstatement of cash is low (e.g., its existence assertion), the auditors may consider other substantive procedures. As an illustration, they might inspect client-provided bank statements. Additional information on the confirmation process is provided in Chapter 11.

3. Obtain or Prepare Reconciliations of Bank (Financial Institution) Accounts as of the Balance Sheet Date and Consider the Need to Reconcile Bank Activity for Additional Months.

Determining a company's cash position at the close of the period requires a reconciliation of the balance per the bank statement at that date with the balance per the company's

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Accuracy	☒
Cutoff	☒
Rights	☒

accounting records. Even though the auditors may not be able to begin their fieldwork for some time after the close of the year, they will prepare a bank reconciliation as of the balance sheet date or test the one prepared by the client.

If the client has prepared the year-end reconciliation, there is no need to duplicate the work. However, the auditors should examine the reconciliation in detail to satisfy themselves that it has been properly prepared. Inspection of a reconciliation prepared by the client may include verifying the mathematical accuracy, comparing balances to the bank statement and ledger account, and investigating the reconciling items. The importance of a careful review of the client's reconciliation is indicated by the fact that a cash shortage may be concealed merely by omitting a check from the outstanding check list, by purposely making an error in addition on the reconciliation, or by hiding cells in a spreadsheet schedule.

There are many satisfactory forms of bank reconciliations. The form most frequently used by auditors begins with balance per bank and ends with unadjusted balance per the accounting records. The format permits the auditors to post adjusting entries affecting cash directly to the bank reconciliation working paper so that the final adjusted balance can be cross-referenced to the cash lead schedule or to the working trial balance.

The mechanics of balancing the ledger account with the bank statement by no means completes the auditors' verification of cash on deposit. The authenticity of the individual items making up the reconciliation must be established by reference to their respective sources. The balance per the bank statement, for example, is not accepted at face value but is verified by direct confirmation with the bank, as described in the last section. Other verification procedures associated with the reconciliation of the bank statement will now be discussed.

The auditors should consider investigating any significant checks outstanding for a long period of time (e.g., six months). If checks remain outstanding for long periods, internal control over cash disbursements is weakened. Employees who become aware that certain checks have long been outstanding and may never be presented have an opportunity to conceal a cash shortage merely by omitting the old outstanding check from the bank reconciliation. Such omissions will serve to increase the apparent balance of cash on deposit and may thus induce an employee to abstract a corresponding amount of cash on hand. It is good practice for the client to eliminate long-outstanding checks of this nature by an entry debiting the Cash account and crediting Unclaimed Wages or another special liability account. This will reduce the work required in bank reconciliations, as well as lessen the opportunity for fraud.

When internal control over the recording of cash receipts and disbursements is considered weak, the auditors may use additional reconciliation procedures. For example, a **proof of cash** may be prepared, which, in addition to reconciling the account balance, reconciles cash transactions occurring during a specified period. Specifically, the technique is used to identify

- Cash receipts and disbursements recorded in the accounting records, but not on the bank statement.
- Cash deposits and disbursements recorded on the bank statement, but not in the accounting records.
- Cash receipts and disbursements recorded at different amounts by the bank than in the accounting records.

A proof of cash is essentially a fraud detection procedure that may be used for any months during the year.

A proof of cash for the test period of September is illustrated in Figure 10.7. Notice that this working paper is so organized that the first and last columns reconcile the cash balance per bank and the balance per accounting records at the beginning of the test period (Column 1) and at the end of this period (Column 4). These outside columns are equivalent to typical monthly bank reconciliations. The two middle columns reconcile

FIGURE 10.7 Proof of Cash

THE FAIRVIEW CORPORATION Account No. 101 Proof of Cash for September 20X1 December 31, 20X1					A-6 SM 11/15/X1
	Balance 8/31/X1		Deposits	Checks and Charges	Balance 9/30/X1
Per Bank Statement	\$39,236.40	✓	\$46,001.00	✓	\$44,874.50
Deposits in Transit					
at 8/31/X1	600.00	✓	(600.00)		
at 9/30/X1			837.50		837.50
Outstanding Checks					
at 8/31/X1	(1241.00)	✓		(1241.00)	
at 9/30/X1				3402.00	(3402.00)
Bank Service Charge					
August	4.60	✓		4.60	
September				(2.80)	2.80
Check of customer A.D. Speeler charged back by Bank 9/12/X1, redeposited 9/12/X1			(900.00)	(900.00)	
Per Books	<u>\$38,600.00</u>	∞	<u>\$45,338.50</u>	<u>\$ 41,625.70</u>	<u>\$ 42,312.80</u>
					∞

✓ Traced to client's 8/31/X1 bank statement.
 ✓ Traced to client's 9/30/X1 bank statement.
 ✓ Per adding machine tape at A-4-2.
 ✓ Per adding machine tape at A-4-3.
 ∞ Traced to general ledger.

Footed cash receipts journal and check register for 9/X1. Accounted for numerical sequence of all checks issued September 20X1 (26610-6792). No exceptions noted.

K.W. 10/16/X1

the bank's record of deposits with the client's record of cash receipts (Column 2) and the bank's record of paid checks with the client's record of cash disbursements (Column 3).

Next, consider the source of the figures used in this reconciliation. The amounts "per bank statement" are taken from the September 30 bank statement. The subsequent rows of deposits, checks, and other items are taken from the August and September bank reconciliations, and the amounts "per books" are taken from the client's Cash general ledger account and cash receipts and disbursements journals.

4. Obtain a Cutoff Bank Statement Containing Transactions of at Least Seven Business Days Subsequent to the Balance Sheet Date.

A **cutoff bank statement** is a statement covering a specified number of *business days* (usually 7 to 10) following the end of the client's fiscal year. The client will request the bank to prepare such a statement and mail it directly to the auditors. The auditors also may obtain cutoff information electronically from the bank's website. In order to accept this as appropriate evidence, the auditors should become satisfied that the website is valid. This information is used to test the accuracy of the year-end reconciliation of the company's bank accounts. It allows the auditors to examine firsthand the checks

Primary Audit Objectives:	
Existence	✓
Occurrence	✓
Accuracy	✓
Cutoff	✓
Rights	✓

(ordinarily on computer media) listed as outstanding and the details of deposits in transit on the company's reconciliation.

With respect to checks that were shown as outstanding at year-end, the auditors should determine the dates on which the bank paid these checks. By noting the dates of payment of these checks, the auditors can determine whether the time intervals between the dates of the check and the time of payment by the bank were unreasonably long. Unreasonable delay in the presentation of these checks for payment provides a strong indication that the checks may not have been mailed by the client until some time after the close of the year. The appropriate adjusting entry in such cases consists of a debit to Cash and a credit to a liability account.

In examining the cutoff bank statement, the auditors also will watch for any paid checks issued on or before the balance sheet date but not listed as outstanding on the client's year-end bank reconciliation. Thus, the cutoff bank statement provides assurance that the amount of cash shown on the balance sheet was not overstated by omission of one or more checks from the list of checks outstanding.

Check 21 Act

Historically, checks have taken days to clear in large part because they have literally been flown about the country in the clearing process. Under the **Check Clearing for the 21st Century Act ("Check 21 Act")**, checks may be processed electronically. Electronic processing involves creating a "substitute check," an electronic image of the original that is processed in hours rather than days. The substitute check is the legal equivalent of the original check for all purposes. Under the Check 21 Act, any financial institution in the check-clearing process may convert (truncate) the physical check into a substitute electronic form for transmission to the paying bank.

This form of check processing has several audit implications. First, if the client's checks are processed electronically, the auditors who wish to see evidence of the check itself must rely upon the substitute check because the original check will no longer be available; the substitute check may be available in paper, electronic, or both forms. Second, it becomes virtually impossible for a client to kite checks (manipulate bank balances so that temporarily overstated cash balances conceal a cash shortage, as discussed later in this chapter) if its financial institutions use this form of processing. However, the auditors should realize that while processing will be much faster, they should still expect reconciliations to include outstanding checks because some checks drawn near the end of the year may be sent through the mail, and some checks will not be promptly presented for payment by payees.

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Accuracy	☒
Cutoff	☒
Rights	☒

5. Identify and Investigate Unusual Cash Receipts and Disbursements.

Based upon their assessment of risks, the auditors should perform procedures to identify and analyze unusual cash receipts or disbursements that may be indicative of material misstatement from fraud or error, or other major issue. When performed manually, these procedures typically involve reviewing cash journals and ledgers for transactions or entries from unusual sources or suspicious individual receipt or disbursement transactions.

However, data analytics may be used to perform these procedures much more efficiently. Data analytics software may perform an examination of 100 percent of the transactions or entries in journals and ledgers using the criteria specified by the auditors. As examples, the auditors may

1. Identify possible duplicate payments by searching for cash disbursements of the same amount and to the same payee made close in time.
2. Identify possible duplicate receipts by searching for cash receipts of the same amount and from the same customer made close in time.
3. Identify possible improper or unexpected disbursements by searching for large disbursements in relation to the account being charged.
4. Identify unauthorized nonpayroll or expense reimbursement cash disbursements to employees, particularly those employees able to initiate or authorize transactions or to perform the record-keeping function for cash disbursements.

5. Identify employees with the largest expense reimbursements and consider reasonableness of disbursements.
6. Identify fictitious entries into the cash account by searching large entries to cash from unusual sources, such as from a journal entry.
7. Identify payments to related party transactions by searching for payments to or receipts from those parties.

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Accuracy	☒
Cutoff	☒
Rights	☒

6. Count and List Cash on Hand.

If the company receives payments from customers, cash on hand consists of undeposited checks. The company also may have a petty cash fund or a change fund. If there are weaknesses in control over cash receipts or the cash funds, the auditors may decide to count them. Petty cash funds and change funds may be counted at any time before or after the balance sheet date; many auditors prefer to make a surprise count of these funds.

The count of cash on hand is of special importance in the audit of banks and other financial institutions. Whenever auditors make a cash count, they should insist that the *custodian of the funds be present throughout the count*. At the completion of the count, the auditors should obtain from the custodian a signed and dated acknowledgment that the funds were counted in the custodian's presence and were returned intact by the auditors. Such procedures avoid the possibility of an employee trying to explain a cash shortage by claiming that the funds were intact when turned over to the auditors.

A first step in the verification of cash on hand is to establish control over all negotiable assets, such as cash funds, securities and other investments, notes receivable, and warehouse receipts. Unless all negotiable assets are verified at one time, an opportunity exists for a dishonest officer or employee to conceal a shortage by transferring it from one asset category to another.

It is not uncommon to find included in cash on hand some personal checks cashed for the convenience of officers, employees, and customers. Such checks should not be entered in the cash receipts journal because, until they are deposited, the checks are merely substitutes for currency previously on hand. The auditors should determine that these checks are valid and collectible, thus qualifying for inclusion in the balance sheet figure for cash.

Primary Audit Objective:	
Cutoff	☒

7. Verify the Client's Cutoff of Cash Receipts and Cash Disbursements.

An accurate cutoff of cash receipts (and of cash disbursements) at year-end is essential to a proper statement of cash on the balance sheet. The balance sheet figure for cash should include all cash received on the final day of the year and none received subsequently. If the auditors can arrange to be present at the client's office at the close of business on the last day of the fiscal year, they will be able to verify the cutoff by counting the undeposited cash receipts. It will then be impossible for the client to include in the records any cash received after this cutoff point without the auditor being aware of such actions.

Of course, the auditors cannot visit every client's place of business on the last day of the fiscal year, nor is their presence at this time normally essential to a satisfactory verification of cash. As an alternative to a count on the balance sheet date, auditors can verify the cutoff of cash receipts by determining that deposits in transit as shown on the year-end bank reconciliation appear as credits on the bank statement on the first business day of the new year. Results of the auditors' consideration of internal control will dictate the necessary scope of these procedures.

The auditors should be aware of possible **window dressing** related to cash transactions. For example, if the cash receipts are not deposited daily, cash received for a few days after the close of the year may be included in a deposit dated as of year-end, thus overstating the cash balance at the balance sheet date.

Other approaches to window dressing improve but do not outright misrepresent the cash position. For example, a corporate officer who has borrowed money from the corporation may repay the loan just before the end of the year and then promptly obtain the loan again after year-end; in such a situation, disclosure in the notes to the financial statements may be appropriate.

Other forms of window dressing do not require action by the auditors. Many companies make strenuous efforts at year-end to achieve an improved financial picture by rushing shipments to customers, pressing for collection of receivables, and sometimes paying liabilities down to an unusually low level. Such efforts to improve the financial picture to be reported are not improper. Before giving approval to the balance sheet presentation of cash, the auditors should exercise their professional judgment to determine whether the client has engaged in window dressing of a nature that causes the financial statements to be misleading.

Primary Audit Objectives:	
Cutoff	☒
Existence	☒
Occurrence	☒
Rights	☒

8. Analyze Bank Transfers for the Last Week of the Audit Year and the First Week of the Following Year.

The purpose of analyzing **bank transfers** is to disclose overstatements of cash balances resulting from **kiting**. Many businesses maintain checking accounts with a number of banks and often find it necessary to transfer funds from one bank to another. When a check drawn on one bank is deposited in another, several days (called the float period) usually pass before the check clears the bank on which it is drawn. During this period, the amount of the check is included in the balance on deposit at both banks. *Kiting* refers to manipulations that utilize such temporarily overstated bank balances to conceal a cash shortage or meet short-term cash needs. Note that kiting is much more difficult in an environment of ever-increasing electronic transfers between accounts (rather than using paper checks) due to the virtual disappearance of the float period.

Auditors can detect manipulations of this type by preparing a schedule of bank transfers (also referred to as an interbank transfer schedule) for a few days before and after the balance sheet date. This working paper lists all bank transfers and shows the dates that the receipt and disbursement of cash were recorded in the cash journals and on the bank statements. A partial illustration of a schedule of bank transfers is shown below.

Check No.	Bank Accounts			Date of Disbursement		Date of Receipt	
	From	To	Amount	Books	Bank	Books	Bank
5897	General	Payroll	\$30,620	12/28	1/3	12/28	12/28
6006	General	Branch 4	24,018	1/2	1/4	12/30	12/30
6029	Branch 2	General	10,000	1/3	1/5	1/3	12/31

Disclosure of Kiting

By comparing the dates on the schedule of bank transfers, auditors can determine whether any manipulation of the cash balance has taken place. The increase in one bank account and decrease in the other bank account should be recorded in the cash journals in the same accounting period. Notice that Check No. 6006 in the transfer schedule was recorded in the cash journals as a receipt on December 30 and a disbursement of January 2. As a result of recording the debit and credit parts of the transaction in different accounting periods, cash is overstated on December 31. For the cash receipts journal to remain in balance, some account must have been credited on December 30 to offset the debit to Cash. If a revenue account was credited, the results of operations were overstated along with cash.

Kiting also may be used to conceal a cash shortage. Assume, for example, that a financial executive misappropriates \$10,000 from a company's general checking account. To conceal the shortage on December 31, the executive draws a check transferring \$10,000 from the company's branch bank account to the general account. The executive deposits the transfer check in the general account on December 31 but records the transfer in the accounting records as occurring early in January. As of December 31, the shortage in the general account has been replaced, no reduction has yet been recorded in the branch account, and no shortage is apparent. Of course, the shortage will reappear in a few days when the transfer check is paid from the branch account.

A bank transfer schedule should disclose this type of kiting because the transfer deposit appears on the general account bank statement in December, while the transaction is not

recorded in the cash journals until January. Check No. 6029 in the transfer schedule illustrates this discrepancy. These illustrations suggest the following rules for determining when it is likely that a cash transfer has misstated the cash balance:

1. The dates of recording the transfer *per the books* (from the cash disbursements and cash receipts journals, respectively) are from different financial statement periods *or*
2. The date the check was recorded *by the bank* (either the disbursement or the receipt, but not both) is from the financial statement period prior to when it is recorded on the books.

A third type of kiting uses the float period to meet short-term cash needs. For example, assume that a business does not have sufficient cash to meet the month-end payroll. The company might draw a check on its general account in one bank, deposit it in a payroll account in another bank, and rely upon subsequent deposits being made to the general account before the transfer check is presented for payment. If the transfer is properly recorded in the accounting records, this form of kiting will not cause a misstatement of the cash balance for financial reporting purposes. However, banks attempt to detect this practice and may not allow the customer to draw against the deposit until the check has cleared the other account. In some deliberate schemes to defraud banks, this type of kiting has been used to create and conceal overdrafts of millions of dollars.

Primary Audit Objectives:
Presentation ☒

9. Investigate Payments to Related Parties.

Any large or unusual checks payable to directors, officers, employees, affiliated companies, or cash should be carefully reviewed by the auditors to determine whether the transactions (1) were properly authorized and recorded and (2) are adequately disclosed in the financial statements.

The auditors should be alert for undisclosed related party transactions throughout the audit. Many of the procedures described above may enable the auditors to identify related party transactions, especially the procedures designed to identify unusual transactions.

To provide assurance that cash disbursements to related parties were authorized transactions and were properly recorded, the auditors should determine that each such transaction has been charged to the proper account, is supported by adequate vouchers or other documents, and was specifically approved in advance by an officer other than the one receiving the funds.

The need for financial statement disclosure of transactions with related parties was discussed in Chapter 5. To determine that such transactions are adequately disclosed, the auditors should obtain evidence concerning the relationship between the parties, the substance of each transaction (which may differ from its form), and the effect of each transaction upon the financial statements. Disclosure of related party transactions should include the nature of the relationships, a description of the transactions, and the dollar amounts involved.

Primary Audit Objectives:
Presentation ☒

10. Evaluate Proper Financial Statement Presentation and Disclosure of Cash.

The balance sheet figure for cash should include only those amounts that are available for use in current operations. A bank deposit that is restricted in use (for example, cash deposited with a trustee for payments on long-term debt) should not be included in cash. Agreements to maintain *compensating balances* should be disclosed. The auditors also must make sure that the caption “Cash” or “Cash and Equivalents” on the client’s balance sheet corresponds to that used in the statement of cash flows.

Interim Audit Work on Cash

To avoid a concentration of audit work shortly after the year-end, CPA firms try to complete as many auditing procedures as possible on an interim basis during the year. The consideration of internal control over cash, for example, can be performed in advance of the client’s year-end. The audit work on cash at year-end can then be limited to such substantive procedures as a review of the client’s bank reconciliations, confirmation of year-end bank balances, investigation of the year-end cutoff, and a general review of cash transactions during the interval between the interim work on cash and the end of the period.

Financial Investments

LO 10-7

Describe the risks involved in auditing financial investments, including why the auditors might need specialized skills.

A particularly important group of financial investments, from the viewpoint of the auditors, consists of marketable stocks and bonds because they are found more frequently and usually are of greater dollar value than other kinds of investment holdings. Other types of investments often encountered include commercial paper issued by corporations, mortgages and trust deeds, and the cash surrender value of life insurance policies for key officers. The auditors also should be concerned with derivatives that are used to hedge various financial and operational risks or for speculation. Derivatives are financial instruments that “derive” their value from other financial instruments, underlying assets, or indexes. For example, a simple derivative would involve a commitment by a company to purchase a commodity at a certain price at some point in the future. Other derivatives are much more complex, involving, for example, relationships between fluctuations in European interest rates and the price of copper.

The Need for Specialized Knowledge

The audit of financial investments can be very complex, requiring specialized skill or knowledge in performing audit tasks such as

- Identifying controls at service organizations that provide financial services and are part of the client’s information system.
- Obtaining an understanding of information systems for securities and derivatives that are highly dependent on computer technology.
- Applying complex accounting principles to various types of financial investments.
- Understanding the methods used to determine the fair values of financial investments, especially those that must be valued using complex valuation models.
- Assessing inherent and control risk for assertions about derivatives used in hedging activities.

Therefore, the auditors may decide that the assistance of a specialist, employed by the auditors, a securities valuation firm, or the client, is needed to assist in the audit of complex financial investments. The audit of very complex financial instruments is often considered a **critical audit matter (CAM)** that must be communicated in the audit report of a public company.

The Auditors’ Objectives in Auditing Financial Investments

The auditors’ *objectives* in the examination of financial investments are to

1. Use their understanding of the client and its environment to assess *inherent risks* including fraud risks.
2. Obtain an understanding of *internal control* over investments.



Illustrative Case

Auditing Derivative Transactions

Enron used derivative contracts in its energy trading division as one way of significantly overstating its reported net income. The company purchased and sold long-term futures contracts for commodities, such as gas, for which there were no active markets and therefore no reliable prices to value the contracts for financial statements.

Company employees, who benefited directly from the profits made from the trading activities, priced the contracts using discretionary valuation models based on their own assumptions and methods. Unrealized trading “gains” accounted for slightly more than half of the company’s \$1.41 billion reported pretax profit for 2000 and about one-third of its reported pretax profit for 1999.

LO 10-8

Identify the auditors' objectives in the audit of financial investments.

3. Assess the risks of *material misstatements* of investments and design further audit procedures that
 - a. Substantiate the *existence* of recorded financial investments and the *occurrence* of investment transactions.
 - b. Establish the *completeness* of financial investments and investment transactions.
 - c. Verify the *cutoff* of investment transactions.
 - d. Determine that the client has *rights* to recorded investments.
 - e. Determine that the *valuation* of financial investments is appropriate; that is, determine that such valuation is in accordance with the cost, fair value, or equity method of accounting and that any unrealized appreciation or depreciation in value is appropriately recorded.
 - f. Determine that the *presentation* and *disclosure* of financial investments and realized and unrealized gains and losses are appropriate.

In conjunction with their audit of financial investments, the auditors also will verify the related accounts of interest income and dividends, accrued interest revenue, and realized and unrealized gains and losses on investments.

The liquid nature of financial investments that are marketable makes the potential for fraud high. Auditors should coordinate their cash and marketable securities audit procedures to detect any possible fraud involving unauthorized substitution (e.g., the sale of securities to hide a cash shortage) between the accounts.

Internal Control over Financial Investments

LO 10-9

Describe typical internal controls over the business processes related to financial investments.

The major elements of adequate internal control over financial investments include the following:

- Formal investment policies that limit the nature of investments in securities and other financial instruments.
- An investment committee of the board of directors that authorizes and reviews financial investment activities for compliance with investment policies.
- Separation of duties between the executive authorizing purchases and sales of securities and derivative instruments, the custodian of the securities, and the person maintaining the records of investments.
- Complete detailed records of all securities and derivative instruments owned and the related provisions and terms.
- Registration of securities in the name of the company.
- Periodic physical inspection of securities on hand by an internal auditor or an official having no responsibility for the authorization, custody, or record keeping of investments.
- Management reviews of the activity in investment accounts and the relationships between amounts of investment income and recorded investments or the amounts of forecasted income.
- Establishing appropriate controls over valuation processes including the use of competent personnel or appropriate outside experts.

In many concerns, segregation of the functions of custody and record keeping is achieved by the use of an independent safekeeping agent, such as a stockbroker, bank, or trust company. Because the independent agent has no direct contact with the employee responsible for maintaining accounting records of the investments in securities, the possibilities of concealing fraud through falsification of the accounts are greatly reduced. If securities that exist in certificate form are not placed in the custody of an independent agent, they should be kept in a bank safe-deposit box under the joint control of two or more of the company's officials. *Joint control* means that neither of the two custodians may have access to the securities except in the presence of the other. A list of securities in the box should be maintained in the box, and the deposit or withdrawal of securities

should be recorded on this list along with the date and signatures of all persons present. The safe-deposit box rental should be in the name of the company, not in the name of an officer having custody of securities.

Complete detailed records of all securities and derivative instruments owned are essential to satisfactory control. These records frequently consist of a subsidiary record for each security and derivative instrument, with such identifying data as the exact name, face amount or par value, certificate number, number of shares, date of acquisition, name of broker, cost, terms, and any interest or dividend payments received. **Management review controls** should also be established by the organization. Actual interest and dividends should be compared to budgeted amounts, and significant variances should be investigated. The purchase and sale of investments often are entrusted to a responsible financial executive, subject to frequent review by an investment committee of the board of directors.

An internal auditor or other responsible employee should, at frequent intervals, inspect the securities on hand, compare the serial numbers and other identifying data of the securities examined with the accounting records, and reconcile the subsidiary record for securities with the control account. If the entity engages in derivative transactions, the individual should also review the terms of derivative instruments for compliance with investment policies and proper financial accounting and disclosure.

If the organization engages in the purchase and sale of complex financial instruments or has significant investments without active markets, it is essential that the company employ personnel with specialized knowledge of securities valuation and accounting. The organization should establish appropriate controls over the selection of the valuation model used as well as the accuracy, completeness, and relevance of related data and assumptions as described in Chapter 7. To assist in the valuation of financial instruments, the organization may employ a specialist or use information from a third party that provides pricing services, such as a securities broker or dealer.

In some situations, the auditors may need to consider controls at a service organization because it provides services that are part of the client's information system. Such services include those that affect the initiation and processing of transactions, creation or update of accounting records, and preparation of financial statements. As an example, the auditors should be concerned about the controls of a stockbroker that initiates purchases and sales of investments and reports the results to the client. As described in Chapter 8, the auditors may obtain information about the controls at a service organization by reviewing user manuals or other systems documentation, reviewing service contracts, obtaining the report of a service auditor, or personally visiting the service organization.

Internal Control Questionnaire

A questionnaire used by the auditors in assessing controls relating to financial investments will include questions such as the following: Does the client have investment policies that reflect appropriate risk management? Are securities and similar instruments under the joint control of responsible officials? Are all persons having access to securities properly bonded? Is an independent safekeeping agent retained? Are competent personnel involved in reviewing, accounting for, and valuing complex financial instruments? Are all purchases and sales of securities and derivatives authorized by a financial executive and reviewed by an investment committee of the board of directors?

Audit of Financial Investments

LO 10-10

Describe tests of controls and substantive procedures used to audit financial investments.

The following steps indicate the general pattern of work performed by the auditors in the audit of financial investments. Selection of the most appropriate procedures for a particular audit will be guided by the nature of the controls that have been implemented and by the results of the auditors' risk assessment process.

- A. Use the understanding of the client and its environment to consider inherent risks, including fraud risks related to financial investments.
- B. Obtain an understanding of internal control over financial investments.

- C. Assess the risks of material misstatement and design further audit procedures.
- D. Perform further audit procedures—tests of controls.
 - 1. Examples of tests of controls:
 - a. Test controls over processing and recording investment transactions by vouching a sample of transactions or using data analytics to test transactions.
 - b. Review and test reports of investment activity prepared for the investment committee.
 - c. Inspect reports by internal auditors regarding their periodic inspection and review of securities and derivative instruments.
 - d. Test **management review controls** by inspecting monthly reports on securities owned, purchased, and sold and amounts of revenue earned and budgeted and by reviewing management follow-up on unusual items or relationships.
 - e. If estimates must be used to develop further estimates of the fair value of investments, perform tests of the processes and controls for developing the estimates.
 - 2. If necessary, revise the risk of material misstatement based on the results of tests of controls.
- E. Perform further audit procedures—substantive procedures for investment transactions and year-end balances.
 - 1. Obtain or prepare analyses of the investment accounts and related revenue, gain, and loss accounts and reconcile them to the general ledger.
 - 2. Inspect securities on hand and review agreements underlying derivatives.
 - 3. Confirm securities and derivative instruments with holders and counterparties.
 - 4. Vouch selected purchases and sales of financial investments during the year and verify the client's cutoff of investment transactions.
 - 5. Review investment committee minutes and reports.
 - 6. Perform analytical procedures or data analytics.
 - 7. Make independent computations of revenue from securities.
 - 8. Inspect documentation of management's intent to classify derivative transactions as hedging activities.
 - 9. Evaluate the method of accounting for investments.
 - 10. Test the estimates of the fair value financial investments, including valuations used for tests of impairment.
 - 11. Evaluate financial statement presentation and disclosure of financial investments.

Risks of Material Misstatement of Financial Investments

As discussed earlier, the fact that securities are often very liquid significantly increases the risk of fraud. In addition, the accounting for financial investments can be very complex, increasing the risk of material misstatement that the investments will not be valued appropriately. That is, valuation is often a relevant assertion for investments. The client may have financial instruments or securities that are valued using accounting estimates. As with all accounting estimates, the auditors must understand the process by which the estimates are developed, identify and assess the risks of material misstatement, and design an appropriate combination of tests of controls and substantive procedures to determine the reasonableness of the estimates. In assessing risks related to the fair value of financial instruments, the auditors should obtain an understanding of the nature of the instruments being valued. Matters that should be considered include (1) the terms and characteristics of the instruments; (2) the extent to which the fair value is based on inputs that are observable; and (3) other factors that bear on the valuation, including credit or counterparty risk, market risk, and liquidity risk. If client personnel engage in speculation, they may be motivated to use various improper techniques to hide or delay reporting losses. The use of derivatives almost always increases the risk of material misstatement of the financial statements. In assessing the risks of material misstatement, the auditors will consider these

FIGURE 10.8 Potential Misstatements—Financial Investments

Description of Misstatement	Examples	Internal Control Weaknesses or Factors That Increase the Risk of the Misstatement
Misstatement of recorded value of investments	Error: - Failure to record changes in market values of investments Fraud: - Misstatement of the value of investments that do not have readily available market values - Recording fictitious securities	- Inadequate controls over the processes for developing estimates of fair value, including use of incompetent personnel - Ineffective board of directors, audit committee, or internal audit function; “tone at the top” not conducive to ethical conduct; undue pressure to meet earnings targets
Unauthorized investment transactions	Fraud: An employee with access to securities converts them for personal use	Inadequate segregation of duties of record keeping for and custody of securities
Incomplete recording of investments	Error: Failure to record derivative agreements that are embedded in other agreements	- Inadequate accounting manual; incompetent accounting personnel - Inadequate monitoring by internal auditors

inherent risks in combination with the control risks identified by the auditors’ understanding of the client and its environment and tests of controls over investments.

Some of the risks of material misstatement identified by the auditors may be so high as to be considered significant risks that require special audit consideration. As an example, if the client uses futures contracts to hedge foreign currency transactions and does not have accounting personnel with adequate knowledge of the related accounting standards, the auditors may decide to evaluate the accounting for all or most of the transactions occurring during the period.

Figure 10.8 provides illustrations of typical errors and fraud that the auditors might identify and assess in the audit of financial investments. Such misstatements may arise due to improper valuation, unauthorized transactions, or inadequate disclosure of such matters as derivative trading activities.

Substantive Procedures for Financial Investments

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Rights	☒

The professional standards (AICPA AU 501; PCAOB AS 2501) provide guidance on auditing accounting estimates, including estimates related to determining the fair value of investments and financial instruments. Figure 10.9 presents the substantive procedures, which are described in the following sections.

1. Obtain or Prepare Analyses of the Investment Accounts and Related Revenue, Gain, and Loss Accounts and Reconcile Them to the General Ledger.

The analysis of financial investments will show the beginning and ending balances for the year, purchases and sales of investments during the year, interest and dividends earned, and realized and unrealized gains and losses. The auditors may verify the beginning balances of investments by reference to the prior year’s audit working papers. If numerous purchases and sales of investments have occurred during the year, separate schedules of those transactions may support an overall summary schedule of investments. The auditors will make certain that totals on the schedules agree with totals recorded in the general ledger.

2. Inspect Securities on Hand and Review Agreements Underlying Derivatives.

The auditors will count securities held by the client at year-end, verify that the securities are registered in the company’s name, and record in the working papers a description

FIGURE 10.9 Objectives of Major Substantive Procedures for Financial Investments

Substantive Procedures	Primary Audit Objectives
Obtain analysis of investments and related accounts and reconcile to ledger.	<i>Existence and rights Occurrence</i>
Inspect securities on hand and review agreements underlying derivatives.	<i>Existence and rights Occurrence and accuracy</i>
Confirm securities and derivative instruments with holders and counterparties.	<i>Completeness Cutoff</i>
Vouch selected purchases and sales of investments during the year.	<i>Valuation</i>
Verify the client's cutoff of investment transactions.	
Review investment committee minutes and reports.	<i>Completeness</i>
Perform analytical procedures or data analytics.	<i>Existence Rights Occurrence Completeness</i>
Inspect documentation of management's intent to classify derivative transactions as hedging activities.	<i>Valuation Presentation</i>
Evaluate the method of accounting for investments and obtain evidence about proper valuation.	
Evaluate financial statement presentation and disclosure of financial investments.	<i>Presentation</i>

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Completeness	☒
Rights	☒
Accuracy	☒
Valuation	☒
Cutoff	☒

of the securities, including the serial numbers. When the client's records indicate that a particular security has been held since the last audit, the auditors may compare the serial number of the certificate with that shown in the prior year's working papers. This will allow the auditors to detect securities that have been sold without authorization during the year and replaced before this year's audit.

While the count of securities ideally is made at the balance sheet date, concurrently with the count of cash and other negotiable instruments, this is not always possible. When not possible, if the securities are kept in a bank safe-deposit box, the client may instruct the bank in writing on the balance sheet date that no one is to have access to the box unless accompanied by the auditors. This arrangement makes it possible to count the securities at a more convenient time after the balance sheet date. Also, banks maintain records of access to safe-deposit boxes that can be examined by the auditors to determine who has had access to the box and at what dates. A representative of the client should be present when the auditors count the securities, and that individual should acknowledge in writing that the securities were returned intact.

The auditors will also review and analyze the **derivative** instruments and other agreements that may contain embedded derivatives. For example, a loan agreement might contain a provision to swap a fixed interest rate for a variable interest rate under certain circumstances. This analysis is designed to determine that all derivatives are properly recorded and valued in the financial statements.

3. Confirm Securities and Derivative Instruments with Holders and Counterparties.

Client-owned securities and other financial instruments will often be in the hands of brokers or banks for safekeeping. In such cases, the auditors send a confirmation request, signed by the client, to the holders of the investments to determine existence, ownership, and, if appropriate, market value. If the broker or bank initiates investment transactions and maintains the related accountability for them, or records investment transactions and processes the related data, the auditors should consider obtaining a service auditor's report on the processing of transactions, as described in Chapter 8. The auditors also

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Rights	☒
Accuracy	☒
Valuation	☒
Cutoff	☒

often confirm the terms of derivative instruments with the counterparties—the other parties obligated under the agreements.

As with cash information from financial institutions, the auditors may decide to get evidence about the client's securities electronically. This approach is appropriate providing that the auditors can be assured that the information is obtained from a valid website without possibility of client manipulation.

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Rights	☒
Accuracy	☒
Valuation	☒
Cutoff	☒

4. Vouch Selected Purchases and Sales of Financial Investments during the Year and Verify the Client's Cutoff of Investment Transactions.

To determine that investments purchased and sold during the period are recorded properly, the auditors vouch a sample of transactions by reference to **brokers' advices** and cash records. In addition, they review transactions for one or two weeks after the balance sheet date to ensure a correct cutoff of transactions. Sometimes sales occur shortly before the balance sheet date but go unrecorded until the securities are delivered to the broker early in the next period. Also, inspection and confirmation procedures will help ensure a proper cutoff of securities transactions.

Primary Audit Objective:	
Completeness	☒

5. Review Investment Committee Minutes and Reports.

Review of investment committee minutes and reports may disclose unrecorded purchases and sales of securities or other financial instruments. This procedure is especially important if the client uses derivatives because transactions giving rise to derivatives may not involve the payment or receipt of cash. For example, if a client engages in a foreign exchange forward contract, there may be no exchange of cash at the time the contract is executed. In addition, derivatives may be embedded in other financial instruments such as a loan agreement.

Primary Audit Objectives:	
Existence	☒
Rights	☒
Occurrence	☒
Completeness	☒

6. Perform Analytical Procedures or Data Analytics.

The auditors can use analytical procedures to test the reasonableness of the amounts of recorded dividend and interest income, or they can verify the amounts by independent computation or the use of data analytics. Dividends that should have been received and recorded can be computed by referring to **dividend record books** published by investment advisory services. These books show dividend declarations, amounts, and payment dates for all listed stocks. Interest earned on bonds and notes also can be computed independently by the auditors and compared with recorded amounts in the client's records. This provides evidence that investment income has not been embezzled, the client actually owns the securities recorded in the accounting records, and there are no unrecorded derivative instruments.

Primary Audit Objectives:	
Valuation	☒
Presentation	☒

7. Inspect Documentation of Management's Intent to Classify Derivative Transactions as Hedging Activities.

To account for a derivative instrument as a hedge of an asset, liability, or futures transaction, management must establish at inception the intent to hedge, the method to be used to assess its effectiveness as a hedge, and the measurement approach for determining the ineffective portion of the hedge. Therefore, review of the documentation of management's intent is essential to the audit of the client's accounting for derivative instruments.

Primary Audit Objectives:	
Valuation	☒
Presentation	☒

8. Evaluate the Methods Used and Obtain Evidence about Proper Valuation.

Organizations have an option in reporting financial investments because they may either follow the guidance in FASB ASC 320 *or* elect the fair value option.² FASB ASC 320 divides debt securities into three portfolios: trading securities, available-for-sale securities, and held-to-maturity securities. Securities in both the *trading* and *available-for-sale* portfolios are valued at their current market values. Any unrealized gains and losses on securities in the trading portfolio are recorded in the income statement; unrealized gains

² Among the accounting pronouncements on fair value are FASB ASC 820 and ASC 825.

and losses on securities classified as available-for-sale are excluded from net income and reported in other comprehensive income in stockholders' equity until they are realized. Equity securities, except those accounted for under the equity method, are valued at fair value unless the value is not readily determinable. Professional standards allow companies to elect the fair value option for all securities; the fair value option results in unrealized gains and losses being recorded on the income statement (as is always the case with trading debt securities and marketable equity securities).

Accounting for derivative instruments is guided by FASB ASC 815 and FASB ASC 825. Under FASB ASC 815, all derivative instruments are valued at their fair values, but the unrealized gains or losses are accounted for differently depending on whether or not the instruments are classified as hedges. Unrealized gains or losses on the effective portions of hedges of recorded assets or liabilities are offset by related increases and decreases in the values of the hedged assets or liabilities. Unrealized gains or losses on the effective portions of hedges of future transactions are recorded as part of other comprehensive income in the client's financial statements. Such gains or losses become adjustments to the recording of the hedged transactions when they occur. Finally, under FASB ASC 815, unrealized gains or losses on the ineffective portions of hedge derivatives and nonhedge derivatives are recorded as a part of net earnings in the client's financial statements. As is the case with other securities, FASB ASC 825 allows an option for companies to choose to use fair value accounting rather than the approach outlined in FASB ASC 815. For derivatives classified as hedges, the auditors should satisfy themselves as to the continued effectiveness of the derivative as a hedge and determine that the gains and losses from the effective and ineffective portions of the hedge are appropriately classified.

The fair value of securities and derivatives in many situations may be obtained by reference to sales prices on organized exchanges (Level 1 valuation). If there is not an active market for the instruments, fair value may be deduced from active markets for similar instruments (Level 2 valuation). However, to use prices from similar markets, the auditors should consider whether adjustments are needed for differences between the instrument being traded in the market and the instrument being valued. Finally, if no active market is available to value the security or derivative, management may have to use a valuation model (Level 3 valuation), such as the Black-Scholes option pricing model.

To audit the fair values of marketable securities or derivatives, current market prices can be obtained by reference to quotes in financial publications, such as *The Wall Street Journal* or various sources on the Internet. Management may also use information from a third party that provides security pricing information, such as an investment reporting service. When fair value information is based on a quote from a broker or dealer, the quality of the evidence provided by the quote depends on a number of factors, including whether (1) the broker or dealer has an affiliation with client management, (2) the broker or dealer is a market maker for the particular instrument, (3) the valuation is based on timely information, (4) the quote is binding on the broker or dealer, and (5) there are any restrictions or limitations of the quote.

Some financial instruments are very complex and cannot be valued by reference to prices on organized markets. Complex instruments may have a mixture of compound rights and obligations, valuation that is contingent on a number of different factors, or unique valuation structures. In valuing these instruments, consideration must be given to

1. the mix of rights and obligations inherent in the instrument;
2. the range of payouts from holding or issuing the instrument; and
3. the likely distribution of payouts from the instrument.

Valuation of such instruments generally requires the development of an estimate of fair value with the use of a valuation model. As with any accounting estimate, the auditors may obtain audit evidence to support the amount by auditing management's process for developing the estimate, developing their own independent estimate of the value, or evaluating audit evidence from events and transactions occurring after the measurement date. Most often, the auditors adopt the first approach. They will evaluate whether the



Illustrative Case

The Mortgage Crisis

A large number of companies, especially financial institutions, invested in mortgage-backed securities prior to 2007. A mortgage-backed security is one that represents an undivided interest in a group of mortgages. Some of these securities were guaranteed by government and private mortgage or bond insurers, such as the Government National Mortgage Association (Ginnie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and MBIA Inc. The combination of increased interest rates, resetting of teaser (low initial) interest rates, and decline in house prices that began in the latter part of 2006 and accelerated in 2007 and 2008

resulted in significant difficulties with regard to the valuation of such securities. The market for mortgage-backed securities dried up, and this led to financial difficulties, including bankruptcies and restructurings of many of the entities that guaranteed these securities. With a lack of good market data, auditors were forced to look to markets for similar securities and models that estimated fair value using discounted cash flows. In an environment of deteriorating markets and increases in default rates, it is easy to see the challenges that auditors faced with evaluating management's assertions about the fair values of these mortgage-based securities.

valuation model used to develop the estimate is in conformity with the requirements of the applicable financial reporting framework and whether it is appropriate for valuation of the particular instrument. The auditors should determine that the model considers all aspects of risk, including counterparty credit risk, risk of adverse changes in market factors, and risk of losses from legal or regulatory action. Assuming the auditors conclude the model is appropriate, they will audit the relevance and reliability of the data used in the model. If the data are internal, the auditors will test the controls over its completeness and accuracy or perform a test of the data directly. They will also evaluate whether the data are sufficiently precise and detailed for purposes of the valuation. If the data are external, the auditors will evaluate their relevance and reliability. Next, the auditors will identify the significant assumptions related to the accounting estimate. Examples of assumptions that would ordinarily be considered significant include those that (1) are sensitive to variation, such that minor changes have a significant effect on the estimate; (2) are susceptible to manipulation or bias; (3) involve unobservable data; or (4) depend on management's intent and ability to carry out specific courses of action. Much of the auditors' work will be focused on determining whether the significant assumptions provide a reasonable basis for the estimate of fair value.

In some cases, the client may engage the services of a specialist to assist in valuing a financial instrument. As discussed in Chapter 5, professional standards require the auditors to consider the professional qualifications and reputation of the specialist and obtain an understanding of the methods and assumptions used. If the client provides data to the specialist to develop the estimate, the auditors should perform tests of the accuracy and completeness of the data. In addition, the auditors must evaluate the significant assumptions assuring that the assumptions have a reasonable basis and are consistent with other information known to the auditors' and management's plans. Finally, the auditors should consider any relationship that the specialist has with the client that could bias the specialist's work.

In some situations, the auditors may engage a specialist to assist in the audit of the fair value estimates of management. The specialist may be employed by an outside firm or employed by the auditors' firm. Chapter 5 provides a discussion of the auditors' responsibilities when using the work of a specialist that is hired or employed by the auditors.

If the company has the positive intent and ability to hold marketable debt securities to maturity, those securities may be classified as *held-to-maturity* and valued at cost, net of any unamortized discount or premium. Nonmarketable securities also are usually valued at cost. When the cost method is used, the auditors determine the value by vouching the original purchase and recomputing any unamortized discount or premium. To determine

that there is no permanent decline in value of the investment, the auditors will obtain information about its current market value. This might require the auditors to audit the fair value of the security as described above.

Investments in common stock that give the investor company the ability to exercise significant influence over operating and financial policies of the investee require use of the equity method of accounting. Ownership of 20 to 50 percent of the voting stock of an investee is used as a general indication of ability to exert influence in the absence of evidence to the contrary. Such factors as investor representation on the investee's board of directors and material intercompany transactions also suggest an ability to exercise influence.

When auditing an investment accounted for by the equity method, the auditors should verify that the investment was properly recorded initially. They also should obtain evidence regarding subsequent amounts of income from the investment and other adjustments to the investment account. This evidence is usually obtained from *audited* financial statements of the investee. However, the auditors must review the financial statements and audit report to determine whether it provides sufficient appropriate evidence.

If the audited financial statements of an investee are not available for the period covered by the independent auditors' report on the investor, or the report is not sufficient, the auditors should perform procedures to obtain sufficient evidence to determine the fairness of amounts recorded by the investor. In some cases, this might involve performing audit procedures at the investee's place of business.

If the auditors find evidence of impairment of the value of any investment, it should be written down to its net realizable value.

Primary Audit Objective:	
Presentation	☒

9. Evaluate Financial Statement Presentation and Disclosure of Financial Investments.

Auditing the presentation and disclosure of financial investments varies depending on whether a company has adopted the fair value option for valuation. If the company has *not* adopted the option, the auditors should determine that investments are properly separated into short-term and long-term portfolios. In addition, generally accepted accounting principles require the disclosure of the method of accounting for the securities and aggregate market values of the various portfolios. Disclosure also must be provided as to the amount of realized and unrealized gains and losses, as well as the allowance for market decline of both the current and long-term portfolios. Finally, the financial statements should disclose the details about debt and equity securities and derivative instruments held at year-end.

If the company adopts the fair value option, the auditors should determine that the disclosures are made in accordance with the appropriate accounting standards. The required disclosures are based largely on the manner in which the fair value hierarchy has been implemented (Chapter 5 presents a discussion of the fair value hierarchy).

Chapter Summary

This chapter described the fundamental controls over cash receipts and disbursements and financial investments. It also explained how the auditors design tests of controls for cash and financial investments and substantive procedures for these accounts. To summarize:

1. Since cash generally has a high degree of inherent risk, more audit time is devoted to the audit of the account than is indicated by its dollar amount.
2. Internal control over cash receipts should provide assurance that all cash received is recorded promptly and accurately. Control over cash sales is strongest when two or more employees participate in each transaction, or when a cash register or an electronic point-of-sale system controls collections. When cash receipts consist of checks received through the mail, the receipts should be listed and controlled by personnel who do not maintain cash or accounts receivable records. The control listing should be reconciled to the entries in the cash receipts journal and deposit records from the financial institution.

3. Internal control over cash disbursements is best achieved when all payments are made by check or well-controlled electronic funds transfers, except for payment of minor items from petty cash funds. Separation of the functions of preparing the payments and signing the checks tends to prevent errors and fraud in cash disbursements.
4. The principal objectives of the substantive procedures for cash are to (a) substantiate the existence of recorded cash and the occurrence of cash transactions, (b) determine the accuracy of cash transactions, (c) establish the completeness of recorded cash, (d) verify the cutoff of cash transactions, (e) determine that the client has rights to recorded cash, and (f) evaluate the adequacy of the presentation and disclosure of the cash accounts. A primary substantive procedure for cash is confirmation of the balances of the company's accounts with financial institutions.
5. The high value and liquid nature of many financial investments make the separation of the authorization, custody, and record-keeping functions especially important. In addition, securities should be registered in the name of the company; complete, detailed records of securities should be maintained; and securities should be physically inspected periodically. Derivative instruments are financial investments that may present significant risks because of the complex accounting and valuation principles that are applicable.
6. Auditors often vouch investment transactions during the year and inspect securities on hand at year-end. The liquid nature of many investments in securities makes cutoff tests especially important. Appropriate accounting for securities and derivatives is very complex and depends on the nature of the instrument and management's intent. Therefore, in auditing the valuation of certain financial investments, the auditors may use the work of a specialist, such as a security appraiser.

Key Terms Introduced or Emphasized in Chapter 10

Bank transfer (476) Moving cash from one bank account to another. The transfer, generally performed electronically, may be between two accounts in the same bank (e.g., general account to payroll account) or from one bank the company maintains an account with to another.

Brokers' advice (484) A notification sent by a stockbrokerage firm to a customer reporting the terms of a purchase or sale of securities.

Canceled checks (466) A check the amount of which has been subtracted from the depositor's account and has been marked as "canceled" by a financial institution. A canceled check has been endorsed by the payee and paid by the drawee financial institution. A canceled check is in contrast to a voided check, a check that has not been processed and will not be.

Check Clearing for the 21st Century Act ("Check 21 Act") (474) This act allows financial institutions to create and process electronic "substitute checks" in place of customer written hard-copy checks. The purpose of this act is to decrease the time for check clearing.

Critical audit matter (CAM) (478) As included in the PCAOB auditing standards, a matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment.

Cutoff bank statement (473) A bank statement covering a specified number of business days (usually 7 to 10) after the client's balance sheet date. Auditors use this statement to determine that checks issued on or before the balance sheet date and paid during the cutoff period were listed as outstanding on the year-end bank reconciliation. Another use is to determine that reconciling items shown on the year-end bank reconciliation have cleared the bank within a reasonable amount of time.

Data analytics (462) Analyses applied to raw data with the purpose of drawing conclusions about relationships. Data analytics is being used by management to get insights into how to improve the effectiveness and efficiency of operations. It is also used as a part of the management review to monitor the performance of other internal controls. Auditors are increasingly using data analytics to improve the effectiveness of certain audit procedures.

Derivatives (483) Financial instruments that "derive" their value from other financial instruments, underlying assets, or indexes. Examples are options, forward contracts, and futures contracts.

Dividend record book (484) A reference book published monthly by investment advisory services reporting detailed information concerning all listed and many unlisted securities; includes dividend dates and amounts, current prices of securities, and other condensed financial data.

Electronic data interchange (EDI) (457) A computer network between companies that allows the interchange of data from one company's computer to the other's (e.g., allows purchases and sales between two firms to be processed electronically).

Electronic funds transfer (EFT) system (457) A computer system that transmits and processes funds-related cash disbursement and receipt transactions. Increasingly, companies are electronically transferring funds between bank accounts rather than issuing checks. See also *electronic data interchange*.

Kiting (476) Manipulations causing an amount of cash to be included simultaneously in the balance of two or more bank accounts. Kiting schemes are based on the float period—the time necessary for a check deposited in one bank to clear the bank on which it was drawn.

Lockbox (456) A post office box controlled by a company's bank at which cash remittances from customers are received. The bank picks up the remittances, immediately credits the cash to the company's bank account, and forwards the remittance advices to the company.

Management review controls (462, 480, 481) Reviews conducted by management of estimates and other kinds of financial information for reasonableness. They often involve the use of significant judgment, knowledge, and experience in comparing recorded amounts with expectations of the reviewers. They often are considered monitoring controls but may relate to any of the other COSO components that have the common characteristic of management review of information to identify misstatements or breakdowns in other controls.

Proof of cash (472) An audit procedure that reconciles the bank's record of cash activity with the client's accounting records for a test period. The working paper used for the proof of cash is a four-column bank reconciliation.

Relevant assertions (465) An assertion about a class of transactions, account balance, or disclosure that has a reasonable possibility (its "likelihood") of being materially misstated (its "magnitude"). A relevant assertion is said to have "an identified risk of material misstatement." The determination of whether an assertion is a relevant assertion is made before considering any related controls (that is, the determination is based on inherent risk).

Risks of material misstatement (465) The risks that the financial statements are misstated. A risk of material misstatement exists when (a) there is a reasonable possibility of a misstatement occurring (that is, its likelihood) and (b) if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude). The risks of material misstatement are addressed by auditors at the *financial statement level* and at the *assertion level*. At the *financial statement level*, it relates to risks that relate pervasively to the financial statement as a whole and potentially may affect many assertions. At the *assertion level*, it relates to specific assertions and consists of two components: inherent risk and control risk.

Significant account (454) An account balance, class of transactions, or disclosure that includes one or more relevant assertions. The determination of significance is made before consideration of any related controls (that is, it is determined based on the assessment of inherent risk). Accordingly, an account balance, class of transactions, or disclosure is considered significant when it has *an identified risk of material misstatement* at the assertion level (that is, there are one or more relevant assertions).

Significant risk (464) An identified risk of material misstatement that, in the auditors' judgment, requires special audit consideration due to their assessment of its inherent risk. The auditors consider the likelihood of misstatement occurring and the magnitude of the potential misstatement both as high. Using the terminology of the AICPA, it is "close to the upper end of the spectrum of inherent risk." Also, professional standards define specific circumstances that constitute significant risks related to revenue recognition and certain related party transactions (AU-C 240 and 550 and PCAOB AS 2110).

Standard confirmation form (469) A confirmation form, agreed to by the AICPA, the American Bankers Association, and the Bank Administration Institute, that is designed to provide corroborating evidence about the client's account balances and outstanding loans.

System and Organization Controls (SOC) Report (471) A report by the auditors of a service organization on the controls over the processing of transactions or data for user organizations. The report is used by the user organizations' auditors in their audits.

Voided check (457) A check that is not negotiable (null and void). A voided check usually results from an error in preparing the check. In contrast, a canceled check is one that has been paid by the bank.

Voucher (459) A document authorizing a cash disbursement. A voucher usually provides space for the initials of employees performing various approval functions. The term *voucher* also may be applied to the group of supporting documents used as a basis for recording liabilities or for making cash disbursements.

Voucher register (459) A special journal used to record the liabilities for payment originating in a voucher system. The debit entries are the cost distribution of the transaction, and the credits are Vouchers Payable. Every transaction recorded in a voucher register corresponds to a voucher authorizing future payment of cash.

Window dressing (475) Action taken by the client shortly before the balance sheet date to improve the financial picture presented in the financial statements.

Review Questions

- 10-1. Describe circumstances that might cause the auditors to identify understatement of assets as a significant audit risk.
- 10-2. Give two reasons audit work on cash is likely to be more extensive than might appear to be justified by the relative amount of the balance sheet figure for cash.
- 10-3. "If the auditors discover any evidence of employee fraud during their work on cash, they should extend their investigation as far as necessary to develop a complete set of facts, regardless of whether the amounts involved are or are not material." Do you agree with the quoted statement? Explain.
- 10-4. It is sometimes said that audit work on cash is facilitated by the existence of two independent records of the client's cash transactions, which are available for comparison by the auditors. Identify these two independent records.
- 10-5. Explain how a lockbox system contributes to internal control over cash receipts.
- 10-6. In a well-controlled IT computer system, the auditors wish to test the control of authorization of cash disbursements. What is the most efficient way that the auditors could test this control?
- 10-7. State one broad general objective of internal control over each of the following: cash receipts, cash disbursements, and cash balances.
- 10-8. Among the departments of J-R Company are a purchasing department, receiving department, accounting department, and finance department. If you were preparing a flowchart of a voucher system to be installed by the company, in which department would you show
 - a. The assembling of the purchase order, receiving report, and vendor's invoice to determine that these documents are in agreement?
 - b. The preparation of a check?
 - c. The signing of a check?
 - d. The mailing of a check to the payee?
 - e. The cancellation of the voucher and supporting documents?
- 10-9. Describe the audit implications of the Check Clearing for the 21st Century Act.
- 10-10. During your audit of a small manufacturing firm, you find numerous checks for large amounts drawn payable to the treasurer and charged to the Miscellaneous Expense account. Does this require any action by the auditor? Explain.
- 10-11. Prepare an example of lapping of cash receipts, showing actual transactions and the cash receipts journal entries.
- 10-12. During your reconciliation of bank accounts in an audit, you find that a number of checks for small amounts have been outstanding for more than a year. Does this situation call for any action by the auditor? Explain.
- 10-13. What information do CPAs request from a financial institution on the standard confirmation form?
- 10-14. How can the auditors corroborate compensating balance arrangements?
- 10-15. What action should be taken by the auditors when the count of cash on hand discloses a shortage?
- 10-16. Explain the objectives of each of the following audit procedures for cash:
 - a. Obtain a cutoff bank statement subsequent to the balance sheet date.
 - b. Compare paid checks returned with the bank statement to the list of outstanding checks in the previous reconciliation.
 - c. Trace all bank transfers during the last week of the audit year and the first week of the following year.
 - d. Investigate any checks representing large or unusual payments to related parties.

- 10-17. Explain two procedures by which auditors may verify the client's cutoff of cash receipts.
- 10-18. What is the meaning of the term *window dressing* when used in connection with year-end financial statements? How might the term be related to the making of loans by a corporation to one or more of its executives?
- 10-19. An audit client that has never before invested in securities recently acquired more than a million dollars in cash from the sale of real estate no longer used in operations. The president intends to invest this money in marketable securities until such time as the opportunity arises for advantageous acquisition of a new plant site. He asks you to enumerate the principal factors you would recommend to create strong internal control over marketable securities.
- 10-20. A well-financed audit client of your CPA firm invests large amounts in marketable securities. As part of its internal control, the company uses a monthly report of securities transactions. The report is prepared by the controller and presented to the investment committee of the board of directors. What information should this report contain?
- 10-21. What information should be noted by the auditors during their inspection of securities on hand?
- 10-22. Salvador Corporation made an investment in Letter.com Inc. in exchange for 100,000 options to purchase Letter.com's stock at \$20 per share. Since the stock options are not marketable, Salvador's management has this derivative valued by a security appraiser. The appraiser uses an option-pricing model to determine the fair value of the derivative for the financial statements. Describe how you would audit the valuation of the stock options.
- 10-23. In what ways can the audit of financial investments present special risks requiring specialized skill and knowledge?
- 10-24. How can the auditors determine that all dividends applicable to marketable securities owned by the client have been received and recorded?
- 10-25. If a security or derivative is not marketable, how do the auditors typically obtain evidence about the fair value of the instrument?

Questions Requiring LO 10-3 Analysis

Select questions are available with Connect



- 10-26. Fluid Controls Inc., a manufacturing company, has retained you to perform an audit for the year ended December 31. Prior to the year-end, you begin to obtain an understanding of the new client's controls over business processes related to the cash account.
You find that nearly all the company's cash receipts are in the form of checks received through the mail, but there is no prelisting of cash receipts before they are recorded in the accounts. Also, the incoming mail is opened either by the cashier or by the employee maintaining the accounts receivable subsidiary ledger, depending on which employee has time available. The controller stresses the necessity of flexibility in assignment of duties to the 20 employees comprising the office staff, in order to keep all employees busy and achieve maximum economy of operation.
 - a. Explain how prelisting of cash receipts strengthens internal control.
 - b. List specific duties that should not be performed by an employee assigned to prelist the cash receipts in order to avoid any opportunity for that employee to conceal embezzlement of cash receipts.

(AICPA, adapted)
- LO 10-4, 5 10-27. Henry Mills is responsible for preparing checks, recording cash disbursements, and preparing bank reconciliations for Signet Corporation. While reconciling the October bank statement, Mills noticed that several checks totaling \$9,370 had been outstanding for more than one year. Concluding that these checks would never be presented for payments, Mills prepared a check for \$9,370 payable to himself, forged the treasurer's signature, and cashed the check. Mills made no entry in the accounts for this disbursement and attempted to conceal the theft by destroying the forged check and omitting the long-outstanding checks from subsequent bank reconciliations.
 - a. Identify the weaknesses in Signet Corporation's internal control.
 - b. Explain several audit procedures that might disclose the fraudulent disbursement.
- LO 10-3, 5, 6 10-28. Assume that you are auditing the financial statements of Young Manufacturing Co. Management of Young has designed a review control for cash disbursements using data analytics. The company's software examines all disbursements for duplicate payments, unusual

payees, large amounts, material variances from expected amounts, and unusual relationships between amounts and expense category. The company's controller reviews the items identified for needed corrections and implications for the performance of other controls. Assume that you wish to consider this control in your audit of cash payments and expenses and you have already tested controls over the company's computer system.

- a. Describe how you would test the design effectiveness of this management review control.
- b. Describe how you would test the operating effectiveness of this management review control.

LO 10-4, 5 10-29. An assistant auditor received the following instructions from her supervisor: "Here is a cutoff bank statement covering the first seven business days of January. Compare the paid checks returned with the statement and dated December 31 or earlier with the list of checks outstanding at December 31." What type of fraud might this audit procedure bring to light? Explain.

LO 10-4, 5 10-30. "When auditors are verifying a client's bank reconciliation, they are particularly concerned with the possibility that the list of outstanding checks may include a nonexistent or fictitious check, and they also are concerned with the possibility of omission from the reconciliation of a deposit in transit." Criticize the above quotation and revise it into an accurate statement.

LO 10-10 10-31. Metropolitan Corporation has a significant investment in a closely held corporation, Wake Forest Company. Metropolitan's investment does not enable the company to exercise significant influence over the operating and financial operations of Wake Forest. To evaluate whether the investment is impaired, management of Metropolitan has engaged a securities valuation firm to value the investment. In your audit of Metropolitan, you have been provided with the valuation report of the securities valuation firm.

- a. Describe the procedures that you should perform in evaluating the evidence provided by the report.
- b. How would you determine which assumptions in the report are significant?

LO 10-3, 5, 6 10-32. In the audit of Wheat Inc. for the year ended December 31, you discover that the client had been drawing checks as creditors' invoices became due but had not been mailing the checks immediately. Because of a working capital shortage, some checks have been held for two or three weeks.

The client's controller informs you that unmailed checks totaling \$48,500 were on hand at December 31 of the current year. He states that these December-dated checks had been entered in the cash disbursements journal and charged to the respective creditors' accounts in December because the checks were prenumbered. However, these checks were not actually mailed until early January. The controller wants to adjust the cash balance and accounts payable at December 31 by \$48,500 because the Cash account had a credit balance. He objects to submitting to his bank your audit report showing an overdraft of cash.

Discuss the propriety of adjusting the cash balance and accounts payable by the indicated amount of outstanding checks.

LO 10-3, 6 10-33. Explain how each of the following items would appear in a four-column proof of cash for the month of November. Assume the format of the proof of cash begins with bank balances and ends with the unadjusted balances per the accounting records.

- a. Outstanding checks at November 30.
- b. Deposits-in-transit at October 31.
- c. Check issued and paid in November, drawn payable to Cash.
- d. The bank returned \$1,800 in NSF checks deposited by the client in November; the client redeposited \$1,450 of these checks in November and \$350 in December, making no additional entries in the accounting records.

LO 10-9, 10 10-34. During the current year, the management of Hanover Inc. entered into a futures contract to hedge the price of silver that will be needed for next year's production. The contract, which is held by Hanover's commodity broker, is marketable and exchanged on the CME Globex Exchange.

- a. Describe the types of controls that should be established by a company that engages in derivative trading.
- b. List the substantive procedures that the auditors would use to audit this derivative.

- LO 10-5, 6** 10–35. During your audit of Miles Company, you prepared the following bank transfer schedule:

MILES COMPANY Bank Transfer Schedule December 31, 20X1							
Check Number	Bank Accounts		Amount	Date Disbursed		Date Deposited	
	From	To		Books	Bank	Books	Bank
2020	1st Natl.	Suburban	\$32,000	1/4	1/5	12/31	1/3
2021	1st Natl.	Capital	21,000	12/31	1/4	12/31	1/3
3271	2nd State	Suburban	6,700	1/3	1/5	1/3	12/30
0659	Midtown	Suburban	5,500	12/30	1/5	12/30	1/3

- Describe the purpose of a bank transfer schedule.
- Identify those transfers that should be investigated and explain the reason.

(AICPA, adapted)

- LO 10-6** 10–36. Based on an assessment of audit risk, the auditors are concerned with the following two risks:
- The risk that the client might be making duplicate payments to vendors.
 - The risk that the client's accounting clerk might be making unauthorized payments to himself.
- Assuming that the client has a manual accounting system, describe how the auditors can design a test to identify the duplicate payments and unauthorized payments.
 - Assuming that the client has an IT accounting system, describe how the auditors might use data analytic software to design a test to identify the duplicate payments and the unauthorized payments.
 - Describe the advantages of using data analytics software to identify unusual transactions or entries.
- LO 10-8, 10** 10–37. You are the auditor-in-charge of the audit of Steffens Corporation. In the audit of investments, you have just been given the following list of securities held by Steffens Corporation at December 31, 20X3.

STEFFENS CORPORATION Schedule of Marketable Securities December 31, 20X3	
	Market Value December 31
10,000 shares of Microsoft Corp.	\$599,100
6,000 shares of General Motors Corp.	216,500
8,000 shares of Beta Corporation	(not publicly traded)
400 Holloway Lodging Corp. 7.5% Convertible Bonds	555,000

- Identify the potential audit problems that may be indicated by the schedule.
- To value the shares of Beta Corporation, management has employed a securities valuation firm. Explain the audit considerations involved in auditing the value developed by the valuation firm.

- LO 10-6** 10–38. Assume that you are performing the audit of Cameron Mfg. Co. Cameron has an IT system and you have evaluated and tested the general controls and found them to be effective. Also assume that the company has the typical control procedures for controlling cash disbursements. Assume that you are currently designing tests of the application controls over cash disbursements and have been provided with the following two data files.

Cash Disbursement Transactions File									
Vendor No.	Vendor Invoice No.	Date Received	Type of transaction Service or Goods	Receiving Report No.	Invoice Amount	ID of Individual Approving Payment	Due date	Check No.	Payee

Cash Vendor File		
Vendor No.	Vendor Name	Initials of Individual Approving Vendor

- Describe three tests of controls that you might perform using data analytics.
- Assume that you find a number of cash disbursements with payees that do not correspond to vendor names. What is the implication of this finding?

Objective Questions

LO 10-3

10–39. Multiple Choice Questions

Select the best answer for each of the following situations and give reasons for your choice.

LO 10-3

- a. Which of the following controls would most likely reduce the risk of diversion of customer receipts by a client's employees?
- (1) A bank lockbox system.
 - (2) Prenumbered remittance advices.
 - (3) Monthly bank reconciliations.
 - (4) Daily deposit of cash receipts.

LO 10-5

- b. To provide assurance that each voucher is submitted and paid only once, the auditors most likely would examine a sample of paid vouchers and determine whether each voucher is:
- (1) Supported by a vendor's invoice.
 - (2) Stamped "paid" by the check signer.
 - (3) Prenumbered and accounted for.
 - (4) Approved for authorized purchases.

LO 10-6

- c. In testing controls over cash disbursements, the auditors most likely would determine that the person who signs checks also:
- (1) Reviews the monthly bank reconciliation.
 - (2) Returns the checks to accounts payable.
 - (3) Is denied access to the supporting documents.
 - (4) Is responsible for mailing the checks.

LO 10-7, 10

- d. To gather evidence regarding the balance per bank in a bank reconciliation, the auditors would examine any of the following *except*:
- (1) Cutoff bank statement.
 - (2) Year-end bank statement.
 - (3) Bank confirmation.
 - (4) General ledger.

LO 10-5

- e. You have been assigned to the year-end audit of a financial institution and are planning the timing of audit procedures relating to cash. You decide that it would be preferable to:
- (1) Count the cash in advance of the balance sheet date in order to disclose any kiting operations at year-end.
 - (2) Coordinate the count of cash with the cutoff of accounts payable.
 - (3) Coordinate the count of cash with the count of marketable securities and other negotiable assets.
 - (4) Count the cash immediately upon the return of the confirmation letters from the financial institution.

LO 10-3

- f. Which of the following procedures would the auditors most likely perform to test controls relating to management's assertion about the completeness of cash receipts for cash sales at a retail outlet?
- (1) Observe the consistency of the employees' use of cash registers and tapes.
 - (2) Inquire about employees' access to recorded but undeposited cash.
 - (3) Trace deposits in the cash receipts journal to the cash balance in the general ledger.
 - (4) Compare the cash balance in the general ledger with the bank confirmation request.

LO 10-4, 6

- g. Reconciliation of the bank account should not be performed by an individual who also:
- (1) Processes cash disbursements.
 - (2) Has custody of securities.
 - (3) Prepares the cash budget.
 - (4) Reviews inventory reports.
- h. The auditors suspect that a client's cashier is misappropriating cash receipts for personal use by lapping customer checks received in the mail. In attempting to uncover this embezzlement scheme, the auditors most likely would compare the:
- (1) Details of bank deposit slips with details of credits to customer accounts.
 - (2) Daily cash summaries with the sums of the cash receipts journal entries.
 - (3) Individual bank deposit slips with the details of the monthly bank statements.
 - (4) Dates uncollectible accounts are authorized to be written off with the dates the write-offs are actually recorded.

LO 10-9

i. In order to guard against the misappropriation of company-owned marketable securities, which of the following is the *best* course of action that can be taken by a company with a large portfolio of marketable securities?

- (1) Require that one trustworthy and bonded employee be responsible for access to the safekeeping area where securities are kept.
- (2) Require that employees who enter and leave the safekeeping area sign and record in a log the exact reason for their access.
- (3) Require that employees involved in the safekeeping function maintain a subsidiary control ledger for securities on a current basis.
- (4) Require that the safekeeping function for securities be assigned to a bank or stockbroker that will act as a custodial agent.

LO 10-9

j. Hall Company had large amounts of funds to invest on a temporary basis. The board of directors decided to purchase securities and derivatives and assigned the future purchase and sale decisions to a responsible financial executive. The best person or persons to make periodic reviews of the investment activity would be:

- (1) An investment committee of the board of directors.
- (2) The chief operating officer.
- (3) The corporate controller.
- (4) The treasurer.

LO 10-10

k. The auditors who physically examine securities should insist that a client representative be present in order to:

- (1) Detect fraudulent securities.
- (2) Lend authority to the auditors' directives.
- (3) Acknowledge the receipt of securities returned.
- (4) Coordinate the return of securities to the proper locations.

LO 10-7, 10

l. The best way to verify the amounts of dividend revenue received during the year is:

- (1) Recomputation.
- (2) Verification by reference to dividend record books.
- (3) Confirmation with dividend-paying companies.
- (4) Examination of cash disbursements records.

LO 10-1, 2, 3, 4, 6 10–40.

Simulation

You are working on your firm's fifth audit of SSC. The previous audits have all resulted in standard unqualified audit reports. Read the following write-up from your audit files concerning SSC and its industry, and then reply to the questions that follow.

Company Information

In 20X1, Gary Sherwood founded Sherwood Stone Company (SSC). In the middle of its second year of existence, the company completed development of a large extraction pit area and constructed an aggregate processing plant that is equipped to crush, screen, and wash aggregate products. By 20X4, the sand and gravel operation was profitable and growing market conditions justified modifications and expansion. Currently, SSC produces a wide range of sand and stone products from its pit near Bisbee, Arizona. The materials it develops are composed of sand and stone materials for commercial construction and highway projects.

SSC sells to a wide variety of commercial and governmental customers, with only one of its numerous customers—Wingo Corporation—accounting for more than 5 percent of total sales. In total, Wingo has represented approximately 30 percent of sales (and receivables) for the past few years. Wingo Corporation is by far Arizona's largest street and road contractor and seems solid financially. Virtually all of SSC's sales are on credit, although all but the smallest contracts require "progress" billings that result in payment being received by SSC on a pro rata basis with delivery of materials to the customer. Payments from customers are made directly to the company's lockbox system with SSC's local bank. All transactions occur in U.S. dollars, and SSC maintains both a general checking account and a payroll account.

SSC has worked closely with Wingo Corporation in developing a superior road paving product ("QuietRide"). Not only is the car ride relatively quiet on QuietRide roads, but it is also relatively cool (thus lengthening the life of automobile tires) and less likely to lead to cars sliding in rainy conditions. Although Wingo Corporation holds the overall patent, SSC has patented a critical component that is used in the product (the component is "QSand"). The product now accounts for approximately 25 percent of the company's sales (all to Wingo Corporation) and 33 percent of its profits.

The success of QSand has led SSC to start developing another product, QDeck. QDeck will be a final finishing coat over the pool deck—the concrete walking and lounging area that surrounds a swimming pool. QDeck is intended to address two problems: (1) individuals slipping and falling on pool decks while walking with wet feet and (2) individuals burning their feet on the deck on particularly hot days. Gary indicates that the current compound seems to allow good traction and decks remain much cooler than with products of other companies. The problem being addressed at this point is that the current compound seems to crack easily and has a relatively short useful life. Indeed, in one test of the product on the deck at Gary's home, Gary's wife Madonna cut her foot on one of the cracks and required several stitches to close the wound. Gary laughed and said that at least she didn't slip or burn her feet on that hot day when it happened. More seriously, he suggested that this deficiency is currently being worked on and must be solved before the product goes to market. The product is being independently developed and is intended for both residential and commercial markets.

In 20X8, the company experienced a level of profitability just slightly above that of 20X7—but this was well below the net incomes of the preceding few years. Gary suggested to you that, surprisingly, intense price competition from several smaller competitors in the Bisbee area caused the somewhat low level of profitability. But, he added, he didn't expect the problem to last for long because he doubted that those companies could continue to operate selling at those lower prices. Gary had hoped for a more profitable year in 20X8, as a significant amount of the company's long-term debt is payable in 20X9. SSC is currently involved in discussions with the bank on refinancing.

SSC added significant additional crushing and washing plant and equipment during 20X8 to increase production in the future by more than 100 percent while expanding capabilities to produce custom specification materials.

No dividends have been paid during the past two years, although previously most of the earnings were distributed through dividends to SSC's five shareholders—CEO and Chair of the Board of Directors Gary Sherwood, his wife Madonna Sherwood, CFO Jane Zhan, and two college friends of Gary's who invested in the company, Cindy Stone and Kelly Higgins. These five individuals make up the company's board of directors.

The Bank of Arizona is the financial institution with which SSC maintains its two cash accounts (general and payroll cash accounts) and from which it obtains a significant portion of its financing; the inventories are pledged on the Bank of Arizona loan. This year, in reaction to pressure from the bank, SSC established an audit committee composed of Madonna Sherwood, Cindy Stone, and Kelly Higgins.

Industry Information

The industry activities consist of the extraction and preparation of sand and rock products. These activities include the cleaning, separating, and sorting of quarried sand and the process of crushing rocks. The products are in the form of sand used in making concrete; sand used in laying bricks (which contains little soil); sand used for fill (which contains a large amount of soil); and quartz sand. It excludes the products of gravel quarrying (sandstone, gravel stone, and iron sand).

While sales within the industry are relatively unaffected by changes in technology or obsolescence, industry sales rely heavily upon both the residential and commercial construction markets as well as government spending. During the past five years, construction has performed well and that trend is expected to continue for at least the next several years. Sand and gravel production has increased at approximately 4 percent per year during this time period, as has construction within the central Arizona area.

Questions

- a. Which of the following represents a correct statement concerning the risk of misappropriation of cash for SSC?
 - (1) This is not a major concern because sales are made on credit.
 - (2) Deposit of cash into a lockbox system decreases the risk of misappropriation.
 - (3) Misappropriation of cash is not a significant problem in a commercial company.
 - (4) The success of QSand increases the risk that cash will be misappropriated.
- b. Which of the following correctly identifies a risk facing SSC that might adversely affect cash receipts during the coming years?
 - (1) Establishment of the audit committee.
 - (2) Increase in the popularity of home swimming pools.
 - (3) Sales to many different customers.
 - (4) Sales to Wingo.

- c. Which of the following correctly identifies a risk facing SSC that might adversely affect sales during the coming years?
- (1) A general slowdown in the economy.
 - (2) Sales to many smaller customers other than Wingo Corporation.
 - (3) Increased attention to developing new products.
 - (4) A board of directors dominated by management.
- d. Which of the following correctly identifies a risk facing SSC that might affect its ability to continue as a going concern over the long run?
- (1) Competition from several competitors.
 - (2) Your CPA firm's decision to issue standard unmodified audit reports not mentioning the going concern status during the past five years.
 - (3) Obsolescence of all products due to rapid changes in technology in the industry.
 - (4) The nature of inventory items—small in size, high in value.
- e. Of the following, the most significant risk factor relating to the risk of misstatement arising from fraudulent financial reporting for SSC is that:
- (1) Company officers serve on the board of directors.
 - (2) The company must refinance a significant portion of its debt.
 - (3) The company operates in the Bisbee, Arizona, area.
 - (4) The company paid no dividend this year.
- f. In addition to the risk factor identified in the preceding question, another risk factor relating to misstatements arising from fraudulent financial reporting is:
- (1) Earnings this year are lower than management had hoped.
 - (2) Accounts payable are limited to commercial suppliers.
 - (3) Sales are made to residential, commercial, and governmental purchasers.
 - (4) The industry faces great technological changes in almost all of its products.

LO 10-3, 4, 5, 6 10–41. **Adapted AICPA Simulation**

Items *a* through *l* represent possible errors and fraud that you suspect may be present at Rex Company. The accompanying *List of Auditing Procedures* represents procedures that the auditor would consider performing to gather evidence concerning possible errors and fraud. For each item, select one or two procedures, as indicated, that the auditor most likely would perform to gather evidence in support of that item. The procedures on the list may be selected once, more than once, or not at all.

LIST OF AUDITING PROCEDURES

A. Compare the details of the cash receipts journal entries with the details of the corresponding daily deposit slips. B. Scan the debits to the fixed asset accounts and vouch selected amounts to vendors' invoices and management's authorization. C. Perform analytical procedures that compare documented authorized pay rates to the entity's budget and forecast. D. Obtain the cutoff bank statement and compare the cleared checks to the year-end bank reconciliation. E. Prepare a bank transfer schedule. F. Inspect the entity's deeds to its real estate. G. Make inquiries of the entity's attorney concerning the details of real estate transactions. H. Confirm the terms of borrowing arrangements with the lender. I. Examine selected equipment repair orders and supporting documentation to determine the propriety of the charges. J. Send requests to confirm the entity's accounts receivable on a surprise basis at an interim date. K. Send a second request for confirmation of the receivable to the customer and make inquiries of a reputable credit agency concerning the customer's creditworthiness.	L. Examine the entity's shipping documents to verify that the merchandise that produced the receivable was actually sent to the customer. M. Inspect the entity's correspondence files for indications of customer disputes for evidence that certain shipments were on consignment. N. Perform edit checks of data on the payroll transaction tapes. O. Inspect payroll check endorsements for similar handwriting. P. Observe payroll check distribution on a surprise basis. Q. Vouch data in the payroll register to documented authorized pay rates in the human resources department's files. R. Reconcile the payroll checking account and determine if there were unusual time lags between the issuance and payment of payroll checks. S. Inspect the file of prenumbered vouchers for consecutive numbering and proper approval by an appropriate employee. T. Determine that the details of selected prenumbered vouchers match the related vendors' invoices. U. Examine the supporting purchase orders and receiving reports for selected paid vouchers.
-

Possible Misstatements Due to Errors and Fraud

- a. The auditor suspects that a kiting scheme exists because an accounting department employee who can issue and record checks seems to be leading an unusually luxurious lifestyle. **(Select only 1 procedure.)**
- b. An auditor suspects that the controller wrote several checks and recorded the cash disbursements just before year-end but did not mail the checks until after the first week of the subsequent year. **(Select only 1 procedure.)**
- c. The entity borrowed funds from a financial institution. Although the transaction was properly recorded, the auditor suspects that the loan created a lien on the entity's real estate that is not disclosed in its financial statements. **(Select only 1 procedure.)**
- d. The auditor discovered an unusually large receivable from one of the entity's new customers. The auditor suspects that the receivable may be fictitious because the auditor has never heard of the customer and because the auditor's initial attempt to confirm the receivable has been ignored by the customer. **(Select only 2 procedures.)**
- e. The auditor suspects that fictitious employees have been placed on the payroll by the entity's payroll supervisor, who has access to payroll records and to the paychecks. **(Select only 1 procedure.)**
- f. The auditor suspects that selected employees of the entity received unauthorized raises from the entity's payroll supervisor, who has access to payroll records. **(Select only 1 procedure.)**
- g. The entity's cash receipts of the first few days of the subsequent year were properly deposited in its general operating account after the year-end. However, the auditor suspects that the entity recorded the cash receipts in its books during the last week of the year under audit. **(Select only 1 procedure.)**
- h. The auditor suspects that vouchers were prepared and processed by an accounting department employee for merchandise that was neither ordered nor received by the entity. **(Select only 1 procedure.)**
- i. The details of invoices for equipment repairs were not clearly identified or explained to the accounting department employees. The auditor suspects that the bookkeeper incorrectly recorded the repairs as fixed assets. **(Select only 1 procedure.)**
- j. The auditor suspects that a lapping scheme exists because an accounting department employee who has access to cash receipts also maintains the accounts receivable ledger and refuses to take any vacation or sick days. **(Select only 2 procedures.)**
- k. The auditor suspects that the entity is inappropriately increasing the cash reported on its balance sheet by drawing a check on one account and not recording it as an outstanding check on that account and simultaneously recording it as a deposit in a second account. **(Select only 1 procedure.)**
- l. The auditor suspects that the entity's controller has overstated sales and accounts receivable by recording fictitious sales to regular customers in the entity's books. **(Select only 2 procedures.)**

LO 10-6 10–42. **Simulation**

Items *a* through *f* represent the items that an auditor ordinarily would find on a client-prepared bank reconciliation. The accompanying **List of Auditing Procedures** represents substantive auditing procedures. For each item, select one or more procedures, as indicated, that the auditor most likely would perform to gather evidence in support of that item. The procedures on the list may be selected once, more than once, or not at all.

Assume

- The client prepared the bank reconciliation on 10/2/X5.
- The bank reconciliation is mathematically accurate.
- The auditor received a cutoff bank statement dated 10/7/X5 directly from the bank on 10/11/X5.
- The 9/30/X5 deposit in transit; outstanding checks #1281, #1285, #1289, and #1292; and the correction of the error regarding check #1282 appeared on the cutoff bank statement.
- The auditor assessed control risk concerning the financial statement assertions related to cash at the maximum.

List of Auditing Procedures

A. Trace to cash receipts journal.	H. Inspect supporting documents for reconciling item not appearing on cutoff statement.
B. Trace to cash disbursements journal.	I. Trace items on the bank reconciliation to cutoff statement.
C. Compare to 9/30/X5 general ledger.	J. Trace items on the cutoff statement to bank reconciliation.
D. Confirm directly with bank.	
E. Inspect bank credit memo.	
F. Inspect bank debit memo.	
G. Ascertain reason for unusual delay.	
-

GENERAL COMPANY**Bank Reconciliation****1st National Bank of US Bank Account****September 30, 20X5**

a. Select 2 procedures	—	Balance per bank		\$28,375
b. Select 5 procedures	—	Deposits in transit		
		9/29/X5	\$4,500	
		9/30/X5	<u>1,525</u>	<u>6,025</u>
				34,400
c. Select 5 procedures	—	Outstanding checks		
		# 988 8/31/X5	2,200	
		#1281 9/26/X5	675	
		#1285 9/27/X5	850	
		#1289 9/29/X5	2,500	
		#1292 9/30/X5	<u>7,225</u>	<u>(13,450)</u>
				20,950
d. Select 1 procedure	—	Customer note collected by bank		(3,000)
e. Select 2 procedures	—	Error: Check #1282; written on 9/26/X5 for \$270 was erroneously charged by bank as \$720; bank was notified on 10/2/X5		<u>450</u>
f. Select 1 procedure	—	Balance per books		<u>\$18,400</u>

LO 10-4, 6 10-43. **Simulation**

Auditors perform a number of procedures relating to cash—some unique, some not unique. For each substantive procedure below, identify its primary objective or indicate that the procedure serves no purpose.

Substantive Procedures:

- Prepare a bank transfer schedule.
- Prepare a four-column proof of cash.
- Use a standard confirmation form to confirm account balance information.
- Obtain bank cutoff statements.
- Search for large checks to directors, officers, and employees.

Replies: A primary objective of the procedure is to:

- Detect kiting.
- Detect lapping.
- Determine that receivables are converted to cash in a reasonable amount of time.
- Establish the valuation of cash to reflect currency translation losses and gains.
- Reconcile cash receipt and disbursement totals between company records and bank records.
- Verify reconciling items on the year-end bank reconciliation.
- Verify year-end cash and liability balance information.
- Identify related party transactions.
- None. This procedure serves no purpose related to cash.

(AICPA, adapted)

LO 10-6 10–44. **Simulation**

During your audit of Carla Pang Inc., you prepared the following bank transfer schedule.

Check Number	Bank Accounts		Amount	Date Disbursed		Date Deposited	
	From	To		Books	Bank	Books	Bank
2001	City Bank	3rd National	60,000	12/28	12/31	12/28	12/28
2002	City Bank	Portland	80,000	12/28	1/3	12/31	12/31
6734	1st City	City Bank	42,000	1/3	12/31	12/31	12/31
3580	Portland	3rd National	75,000	1/2	1/4	12/30	12/30
2008	City Bank	3rd National	44,000	12/31	1/5	12/31	1/3
2009	City Bank	Portland	67,000	1/1	12/31	1/1	12/31
4005	3rd National	City Bank	33,000	12/31	1/4	1/5	1/5

Fill out the table below indicating the most likely situation as it relates to cash at year-end. Indicate the situation using one of the following:

1. Year-end total cash is properly stated.
2. Year-end total cash is understated.
3. Year-end total cash is overstated.

Check Number	Reply
2001	
2002	
6734	
3580	
2008	
2009	
4005	

LO 10-6 10–45. **Adapted AICPA Simulation**

The auditor of Cubs Co. obtained the following client-prepared bank reconciliation:

ACCOUNT 101-CASH ACCOUNT – FIRST BANK OF MUNICH	
Bank reconciliation—December 31, year 2	
Prepared by: Joe Smith, January 10, year 3	
Reviewed by: Evan Monroe, March 2, year 3	
Balance per bank	\$45,000 ^a
Add deposits in transit	
10/25/year 2	12,000
10/28/year 2	10,000
Deduct outstanding checks	
#28200 03/29/year 2	11,000
#9003 11/30/year 2	14,000
#9004 12/01/year 2	15,000
Other reconciling items	—
Balance per bank adjusted	\$27,000
Balance per books before adjustments	\$32,500
Adjustments: bank fee and unrecorded items	(5,500)
Balance per books, adjusted	\$27,000 ^b

^a Agreed balance per bank to online account balance as of January 3, year 3.

^b Agreed to general ledger on January 1, year 3.

The auditor for Cubs Co. has obtained the client-prepared bank reconciliation.

The following information is available:

- Evan Monroe was promoted to controller on December 15, year 2; his former position was assistant controller—fixed assets.
- Evan Monroe has his personal bank accounts with First Bank of Munich.
- Joe Smith was hired on December 1, year 2, as a staff accountant.
- Joe Smith's prior job was with First Bank of Munich.
- Cubs expects the year-end close to be complete on January 6, year 3.
- The adjustments on the bank reconciliation were booked on January 30, year 3.

Required:

In the table below, identify six potential issues that the auditor might have when examining the bank reconciliation prepared by Cubs from the list provided of potential issues. An issue may be used once or not at all.

1. Reconciliation is not mathematically accurate.
2. Reconciliation balance was not properly agreed to the December 31 general ledger balance.
3. Reconciliation line item "Other reconciling items" is left blank.
4. Reconciliation was not reviewed in a timely manner.
5. Reconciliation was improperly approved as reviewer had a conflict of interest.
6. Reconciliation has unsubstantiated unrecorded items.
7. Reconciliation contains aged items that should have been added to the bank balance.
8. Reconciliation was improperly prepared by someone with a conflict of interest.
9. Reconciliation does not contain a proper title.
10. Reconciliation does not agree to the cash disbursement subsidiary ledger.
11. Reconciliation was not agreed to bank statement balance at the appropriate date.
12. Reconciliation does not include January, year 3, reconciliation items.
13. Reconciliation was not prepared in a timely manner.
14. Reconciliation was prepared by an inexperienced individual.
15. Reconciliation contains stale checks.

Issues	Potential issue
A	
B	
C	
D	
E	
F	

LO 10-6 10-46. Document Review Simulation

This simulation, also available online, presents the Keystone Computers & Networks, Inc. (Keystone) Cash Work Memo for the general account and petty cash. Background financial and other information on Keystone is included in Appendix 6C of Chapter 6.

The controller of Keystone Computers & Networks Inc. (Keystone), a nonissuer, prepared six exhibits relating to Keystone's General Account cash position at year 5 year-end. A new audit assistant with your CPA firm has begun the audit of cash but has a number of questions and comments based on a quick examination of the exhibits, now included in the working papers, and a discussion of some matters with the controller of Keystone.

Your job as senior on the engagement is to review the various points made by the assistant, including consideration of the exhibits.

DOCUMENT

To: Audit Senior
 From: Audit Assistant
 Re: Keystone Computers & Networks Inc. General Account Cash Work
 Date: January 11, year 6

I have a number of points related to the auditing procedures I applied to Keystone's cash accounts as follows:

1. Cash Lead Schedule (Exhibit 1): The company's petty cash (account 101) is stated at \$50. But the petty cash custodian acknowledges that there was only \$41 in the account as of year-end because a \$9.00 expenditure for supplies had been made. This overstates cash by \$9.00, although pass adjustment due to immateriality. *(Callout #1)*
2. Bank Reconciliation (Exhibit 2): The account receivable collected by the bank was paid by a client directly to the bank on December 29, year 5. Keystone recorded the entry for the proper amount on January 2, year 6. No adjusting entry is needed as of 12/31/year 5. *(Callout #2)*
3. Standard Bank Confirmation (Exhibit 3): The bank representative added a comment to the confirmation. The comment is a "boilerplate" disclaimer of liability that definitely does not affect the reliability of the information we obtained. *(Callout #3)*
4. Deposit in Transit (Exhibit 4): The deposit in transit seems properly handled on the bank reconciliation (Exhibit 2) with a debit to cash. *(Callout #4)*
5. Outstanding Checks (Exhibit 5) and Bank Transfer Schedule (Exhibit 6): Check 2034 from the bank transfer schedule was omitted from the list of outstanding checks. This is because it was not written until 1/1/year 6. *(Callout #5)*
6. Outstanding Checks (Exhibit 5): The long-outstanding check for \$200 will probably never be cashed as the company has attempted to communicate with the payee and failed. Because the state does not require submission of such funds, we should suggest to the client that the \$200 check be deleted from the outstanding check list; no adjusting journal entry seems necessary. *(Callout #6)*
7. Outstanding Checks (Exhibit 5): Keystone's first bank statement in year 6 included check 2027 dated on 12/30 for \$1,500 to Jenco Corp. I found the check to be properly recorded in the cash disbursements journal as of 12/30/year 5. No further audit response is necessary related to check 2027. *(Callout #7)*
8. Bank Transfer Schedule (Exhibit 6): Check 2032 appears to result in the cash being recorded in both accounts per books as of year-end and thus overstates total cash by \$1,500 at year-end. *(Callout #8)*

CALLOUT LIST #1

Choose an option below:

- a. [Original text], although pass adjustment due to immateriality.
- b. as, whenever petty cash is spent, a related journal entry debiting the expense and crediting petty cash should be recorded when an imprest account is used; accordingly, we should propose an adjusting entry.
- c. and indicates we need to perform additional procedures as this imprest account is not being properly used.
- d. and indicates likely fraudulent financial reporting.
- e. and indicates likely misappropriation of assets.

CALLOUT LIST #2

Choose an option below:

- a. [Original text] No adjusting entry is needed as of 12/31/year 5.
- b. [Delete entire point 2]
- c. We should propose an adjusting entry as of 12/31/year 5 debiting cash and crediting accounts receivable for \$6,000.
- d. We should propose an adjusting entry as of 12/31/year 5 debiting cash and crediting miscellaneous revenues as net income is understated as of 12/31/year 5.
- e. We should increase our assessed level of fraud risk due to this situation and propose no adjusting entry as of 12/31/year 5.

CALLOUT LIST #3*Choose an option below:*

- a. [Original text] The comment is a “boilerplate” disclaimer of liability that definitely does not affect the reliability of the information we obtained.
- b. [Delete entire point 3]
- c. Because the bank representative added a disclaimer to the confirmation, we must discard this confirmation and use other auditing procedures to establish the balances.
- d. Because the bank representative added a disclaimer to the confirmation, we are required by the professional standards to consider this a fraud risk factor and to consider the need for additional fraud-related procedures.
- e. Therefore, we are required to reconfirm the account electronically in this circumstance.
- f. This comment (disclaimer) on the confirmation may cast doubt about the completeness and accuracy of the information contained in the response and, accordingly, we should obtain further audit evidence.

CALLOUT LIST #4*Choose an option below:*

- a. [Original text] The deposit in transit seems properly handled on the bank reconciliation (Exhibit 2) with a debit to cash.
- b. [Delete entire point 4]
- c. The deposit in transit is likely to be an interbank transfer between the general account and the special account.
- d. The deposit in transit should be included on the bank transfer schedule.
- e. The deposit in transit seems to have taken too long to reach the bank; we should investigate this further.

CALLOUT LIST #5*Choose an option below:*

- a. [Original text] This is because it was not written until 1/1/year 6.
- b. [Delete entire point 5]
- c. This is because it was written in year 4.
- d. But since the bank transfer schedule shows that it was received on 12/31/year 5 in the special account, we should investigate this transaction further.
- e. This represents a proper deposit in transit for the special account as of 12/31/year 5.

CALLOUT LIST #6*Choose an option below:*

- a. [Original text] be deleted from the outstanding check list; no adjusting journal entry seems necessary.
- b. [Delete entire point 6]
- c. be deleted from the check list, with a possible adjusting journal entry proposed debiting cash and crediting a miscellaneous revenue type account.
- d. be deleted from the check list, with a debit to bad debt expense and a credit to cash.
- e. remain on the list of outstanding checks until cashed to keep the account in balance.
- f. is required to be reissued to a satisfactory charity for disbursement.

CALLOUT LIST #7*Choose an option below:*

- a. [Original text] No further audit response is necessary related to check 2027.
- b. [Delete entire point 7]
- c. We should perform further procedures to determine why the account reconciliation excludes this item, which should be listed as a deposit in transit as of year-end.
- d. We should perform further procedures to determine why the account reconciliation excludes this item, which should be listed as an outstanding check as of year-end.
- e. We should propose an adjusting entry recording the disbursement in December.

CALLOUT LIST #8*Choose an option below:*

- a. [Original text] Check 2032 appears to result in the cash being recorded in both accounts per books as of year-end and thus overstates total cash by \$1,500 at year-end.
- b. [Delete entire point 8]
- c. The transaction related to Check 2032 is either a deposit or a withdrawal; it can't be both.
- d. Check 2032 appears to result in the cash being recorded in both accounts per books as of year-end and thus overstates total cash by \$3,000 at year-end.
- e. Check 2032 is recorded in the general account per bank in year 6; thus, it understates total cash by \$1,500 at year-end.

EXHIBITS

1. Cash Lead Schedule.
2. Bank Reconciliation—General Account
3. Standard Bank Confirmation
4. Deposit in Transit
5. Outstanding Checks—General Account
6. Bank Transfer Schedule—General Account

EXHIBIT 1

Keystone Computers & Networks Inc.
Cash Lead Schedule
12/31/year 5

A/C	Description	Prior Year	Unadj. 12/31/year 5	Dr.	Cr.	Adj. 12/31/ year 5
1000.10	Genl. Acct.	\$42,754.00	\$66,034.15			\$66,034.15
1000.20	Special Acct.	\$ 9,960.00	\$10,150.00			\$10,150.00
1000.30	Cash in Register	\$ 1,200.00	\$ 1,200.00			\$ 1,200.00
1000.40	Petty Cash	\$ 50.00	\$ 50.00*			\$ 50.00*
	TOTAL	\$53,964.00	\$77,434.15	—	—	\$77,434.15

*At year-end, \$41 of cash and a receipt for \$9.00 for postage. *Staff Associate.*

EXHIBIT 2

Keystone Computers & Networks Inc.
Bank Reconciliation—General Account
12/31/year 5

Balance per bank @ 12/31/year 5	\$ 74,636.73
Deposit in transit	15,210.50
Outstanding checks	(17,822.08)
Account Receivable proceeds collected by bank on 12/29*	(6,000.00)
Bank service charge	9.00
Balance per books @ 12/31/year	<u>\$ 66,034.15</u>

*Examined bank statement and identified receivable proceeds deposited in account by bank on 12/29; traced entry to entry in cash receipts journal on 1/2/year 6 when Keystone found out about the deposit made by the bank (Keystone entry: debit Cash, credit Accounts Receivable). *Staff Associate*

EXHIBIT 3

Keystone Computers & Networks Inc.
Standard Bank Confirmation
12/31/year 5

STANDARD FORM TO CONFIRM ACCOUNT
BALANCE INFORMATION WITH FINANCIAL INSTITUTION

ORIGINAL
To be mailed to accountant

Keystone Computers & Networks Inc.

CUSTOMER NAME

Financial
Institution's
Name and
Address

First National Bank
1601 E. Broadway
Tempe, AZ 85282

We have provided to our accountants the following information as of the close of business on 12/31/year5, regarding our deposit and loan balances. Please confirm the accuracy of the information, noting any exceptions to the information provided.

If the balances have been left blank, please complete this form by furnishing the balance in the appropriate space below. Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other deposit and loan accounts we may have with you comes to your attention, please include such information below. Please use the enclosed envelope to return the form directly to our accountants.

1. At the close of business on the date listed above, our records indicated the following deposit balance(s):

ACCOUNT NAME	ACCOUNT NO.	INTEREST RATE	BALANCE
GENERAL	4344-7834	-0-	\$74,636.73

2. We were directly liable to the financial institution for loans at the close of business on the date listed above as follows:

ACCOUNT NO./ DESCRIPTION	BALANCE	DATE DUE	INTEREST RATE	DATE THROUGH WHICH INTEREST IS PAID	DESCRIPTION OF COLLATERAL

Judith Hamilton

(Customer's Authorized Signature)

12/29/year6

(Date)

The information presented above by the customer is in agreement with our records. Although we have not conducted a comprehensive, detailed search of our records, no other deposit or loan accounts have come to our attention except as noted below.

Will Jones

(Financial Institution Authorized Signature)

01/05/year6

(Date)

Assistant Controller

(Title)

EXCEPTIONS AND/OR COMMENTS

Information is not guaranteed to be accurate nor current and may be a matter of opinion.

W.J.

Please return this form directly to our accountants:

Gill & Co, CPA's
2552 E. Camelback Road
Phoenix, AZ 85002

Ordinarily, balances are intentionally left blank if they are not available at the time the form is prepared.

EXHIBIT 4

Keystone Computers & Networks Inc.
Deposit in Transit
12/31/year 5

Copy of Deposit Slip for Deposit in Transit

DEPOSIT SLIP			
Keystone Computers & Networks Inc. PO Box 283353 Tempe, AZ 85282 Date: 12/31, year 5 DEPOSITS MAY NOT BE AVAILABLE FOR IMMEDIATE WITHDRAWAL	Currency	7510.00	DEPOSIT TICKET USE OTHER SIDE FOR ADDITIONAL LISTINGS TOTAL ITEMS BE SURE EACH ITEM IS PROPERLY ENDORSED.
	Coin	500.50	
	Checks		
	Jones 146750	4,000.00	
	Adams 9022	3,200.00	
	Total From Other Side		
	TOTAL		
	Less Cash		
	NET DEPOSIT	15,210.50	

Exhibit 2
f

First National Bank
 1601 E. Broadway
 Tempe, AZ 85282

31133544:

954..54323533

Deposit received by bank on 1/10/year 6. Amount and details consistent.
Staff Associate.

EXHIBIT 5

Keystone Computers & Networks Inc.
Outstanding Checks—General Account 12/31/year 5

Check #	Date	Amount
1237	1/6/year 5	\$ 200.00
2028	12/15/year 5	2.50
2029	12/15/year 5	1,000.00
2030	12/22/year 5	14,757.36
2031	12/29/year 5	40.00
2032	12/31/year 5	1,500.00
2033	12/30/year 5	22.22
2035	12/31/year 5	300.00
		<u>\$17,822.08</u>

Note: Check No. 2034 not listed because it was issued on 1/1/year 6.

Staff prepared the following schedule of transfers **from** the General Account **to** the Special Account.

EXHIBIT 6

Keystone Computers & Networks Inc.
Bank Transfer Schedule—General Account 12/31/year 5

Check No.	Amount	Disbursing Bank (General Account)		Receiving Bank (Special Account)	
		Books	Bank	Books	Bank
2032	\$1,500	12/31/year 5	1/1/year 6	12/31/year 5	12/31/year 5
2034	\$1,650	1/1/year 6	1/1/year 6	1/1/year 5	12/31/year 5
2041	\$1,200	1/3/year 6	1/3/year 6	1/3/year 6	1/3/year 6

Procedures followed:

1. Agreed all disbursements to cash disbursements journal and bank statement (date, check no., amount, payee). No exceptions noted.
2. Agreed all cash receipts to cash receipts journal and bank statement (date, check no., amount, payee). No exceptions noted.

Staff Assistant

1/21/year 6

Problems LO 10-3, 4, 5

10-47. Following are typical questions that might appear on an internal control questionnaire for investments in marketable securities.

1. Is custody of investment securities maintained by an employee who does not maintain the detailed records of the securities?
2. Are securities registered in the company name?
3. Are investment activities reviewed by an investment committee of the board of directors?
 - a. Describe the purpose of each of the above controls.
 - b. Describe the manner in which each of the above procedures might be tested.
 - c. Assuming that the operating effectiveness of each of the above procedures is found to be inadequate, describe how the auditors might alter their substantive procedures to compensate for the increased level of control risk.

LO 10-6

10-48. You are the senior auditor-in-charge of the July 31, 20X0, audit of Reliable Auto Parts Inc. Your newly hired staff assistant reports to you that she is unable to complete the four-column proof of cash for the month of April 20X0, which you instructed her to do as part of the consideration of internal control over cash.

Your assistant shows you the working paper that she has prepared. Your review of your assistant's work reveals that the dollar amounts of all the items in her working paper are correct. You learn that the accountant for Reliable Auto Parts Inc. makes no journal entries for bank service charges or note collections until the month following the bank's recording of the item. In addition, Reliable's accountant makes no journal entries whatsoever for NSF checks that are redeposited and cleared. Your assistant's working paper appears below.

Prepare a corrected four-column proof of cash in good form for Reliable Auto Parts Inc. for the month of April 20X0.

RELIABLE AUTO PARTS INC. Proof of Cash for April 20X0 July 31, 20X0				
	Balance 3/31/X0	Deposits	Checks	Balance 4/30/X0
Per bank statement	\$71,682.84	\$61,488.19	\$ 68,119.40	\$65,051.63
Deposits in transit:				
At 3/31/X0	2,118.18			(2,118.18)
At 4/30/X0		4,918.16		4,918.16
Outstanding checks:				
At 3/31/X0	(14,888.16)		14,888.16	
At 4/30/X0			(22,914.70)	22,914.70
Bank service charges:				
March 20X0	(22.18)		22.18	
April 20X0			(19.14)	19.14
Note receivable collected by bank 4/30/X0		18,180.00		18,180.00
NSF check of customer L. G. Waite, charged back by bank 3/31/X0, redeposited and cleared 4/3/X0	(418.19)	418.19		
Balances as computed	58,472.49	85,004.54	60,095.90	108,964.45
Balances per book	59,353.23	45,689.98	76,148.98	28,894.23
Unlocated difference	\$ (880.74)	\$39,314.56	\$ (16,053.08)	\$80,071.22

- LO 10-4, 5, 6** 10–49. During the audit of Sunset Building Supply, you are given the following year-end bank reconciliation prepared by the client:

SUNSET BUILDING SUPPLY Bank Reconciliation December 31	
Balance per 12/31 bank statement	\$48,734
Add: Deposits in transit	4,467
	<u>\$53,201</u>
Less: Checks outstanding	20,758
Balance per ledger, 12/31	<u><u>\$32,443</u></u>

According to the client's accounting records, checks totaling \$31,482 were issued between January 1 and January 14 of the following year. You have obtained a cutoff bank statement dated January 14 containing paid checks amounting to \$50,440. Of the checks outstanding at December 31, checks totaling \$3,600 were not returned in the cutoff statement, and of those issued per the accounting records in January, checks totaling \$8,200 were not returned.

- Prepare a working paper comparing (1) the total of all checks returned by the bank or still outstanding with (2) the total per the client's records of checks outstanding at December 31 plus checks issued from January 1–14.
- Suggest four possible explanations for the situation disclosed in your working paper. State what action you would take in each case, including any adjusting entry you would propose.

- LO 10-6** 10–50. In your audit of Ginko Company, you have received a cash confirmation and a cutoff statement from the bank on Ginko's one bank account. Prepare a list of substantive procedures for Ginko's cash.

In-Class Team Cases



- LO 10-4, 5, 6** 10–51. Listed below are eight interbank cash transfers for Steven Smith Co., indicated by the letters *a* through *h*, for late December 20X1 and early January 20X2.

	Disbursing Bank (Month/Day)		Receiving Bank (Month/Day)		Amount
	Per Bank	Per Books	Per Bank	Per Books	
<i>a.</i>	12/29	12/29	12/29	12/29	\$52,000
<i>b.</i>	1/02	12/30	12/31	12/30	16,000
<i>c.</i>	1/04	12/31	1/02	1/02	24,000
<i>d.</i>	1/04	12/31	1/02	12/31	44,000
<i>e.</i>	1/04	1/01	1/03	1/01	15,600
<i>f.</i>	1/02	1/01	12/31	12/31	76,000
<i>g.</i>	1/03	1/02	12/31	1/02	42,000
<i>h.</i>	12/31	1/03	12/30	1/03	10,000

For each of the transfers *a* through *h*, (1) indicate whether cash is *understated*, *overstated*, or *correct* as a result of the transfer and (2) provide a brief example of what could cause the situation. Answer in a form such as the one illustrated here.

Transfer	Understated, Overstated, or Correct	Example
<i>a.</i>	Correct	<i>Book entries:</i> The transfer was recorded in the accounting records as a check written on the disbursing bank on December 29 and a corresponding cash receipt recorded to receiving bank on that date. <i>Bank entries:</i> The check was taken to the receiving bank on December 29 and deposited. The accounts are both in the same bank, and accordingly the transaction was recorded in both accounts as of that date.
<i>b.</i>		
⋮		
<i>h.</i>		

- LO 10-1, 2, 4, 5, 6** 10-52. An improper cutoff of transactions around year-end occurs when journal entries are recorded in the wrong year. In this case, you are to determine the effects of various cutoff misstatements relating to recording cash receipts received on accounts receivable and the recording of credit sales. To effectively consider the effects of an improper cutoff, it is helpful to consider the underlying journal entries:

Type of Transactions	Proper Journal Entry (Entries)	
Cash receipt on an account receivable	Cash Accounts Receivable	3,000.00 3,000.00
Credit sale—periodic inventory system	Accounts receivable Sales	2,000.00 2,000.00
Credit sale—perpetual inventory system	Accounts receivable Sales Cost of Goods Sold Inventory	2,000.00 2,000.00 1,300.00 1,300.00

An example of a possible improper cutoff is to “close” the cash receipts journal on December 30 and include December 31 sales in the subsequent year (e.g., the entry is dated January 1 rather than December 31). As a result, cash is understated by \$3,000, while accounts receivable is overstated by \$3,000 for the year just ended. The effects of closing the sales journal depend upon whether a periodic inventory or perpetual inventory system is in use. The effects of “leaving open” journals past year-end and dating January entries as of December may be determined in a similar manner.

Assume that the client made the following actual credit sales and received cash receipts as follows after 12/29/20X8:

	Sales	Cost of Goods Sold	Cash Receipts (Receivables Collected)
12/30/X8	\$1,000	\$ 600	\$4,000
12/31/X8	2,000	1,300	3,000
1/1/X9	3,500	2,200	2,500
1/2/X9	4,000	2,900	3,200

Determine the overstatements and understatements that would result from the following situations. Assume that each situation is independent of one another. As an illustration, situation 1 has been solved for you. To simplify the problem, in the case of a perpetual inventory, assume that the year-end inventory count did not identify and correct the misstatement(s).

Situation	Cash	Acct. Rec.	Inventory	CGS	Sales	Income
1. Zhang Inc. left the cash receipts journal open after year-end for an extra day and included January 1 cash receipts in the December 31 totals. The company uses a periodic inventory system. What effect would this have on 20X8?	\$2,500 (o)	\$2,500 (u)				
2. Zhang Inc. closed the cash receipts journal at 12/29 and reported the last two days of cash receipts in January of 20X9. The company uses a periodic inventory system. What effect would this have on 20X8?						
3. Zhang Inc. left the sales journal open after year-end for an extra day and included January 1 sales in the December 31 totals. The company uses a periodic inventory system. What effect would this have on 20X8?						
4. Same as 3, but the company uses a perpetual inventory system.						
5. Zhang Inc. closed the sales journal at 12/29 and reported the two last days' sales in January of 20X9. The company uses a perpetual inventory system. What effect would this have on 20X8?						
6. Zhang Inc. left both the sales journal and the cash receipts journal open through January 2 and reported the first two days' transactions in December of 20X8. The company uses a periodic inventory system. What effect would this have on 20X8?						

Research and Discussion Case

LO 10-4, 5



- 10–53. On October 21, Rand & Brink, a CPA firm, was retained by Suncraft Appliance Corporation to perform an audit for the year ended December 31. A month later, James Minor, president of the corporation, invited the CPA firm's partners, George Rand and Alice Brink, to attend a meeting of all officers of the corporation. Mr. Minor opened the meeting with the following statement:

All of you know that we are not in a very liquid position, and our October 31 balance sheet shows it. We need to raise some outside capital in January, and our December 31 financial statements (both balance sheet and income statement) must look reasonably good if we're going to make a favorable impression upon lenders or investors. I want every officer of this company to do everything possible during the next month to ensure that, at December 31, our financial statements look as strong as possible, especially our current position and our earnings.

I have invited our auditors to attend this meeting so they will understand the reason for some year-end transactions that might be a little unusual. It is essential that our financial statements carry the auditors' approval, or we'll never be able to get the financing we need. Now, what suggestions can you offer?

The vice president for sales was first to offer suggestions:

I can talk some of our large customers into placing some orders in December that they wouldn't ordinarily place until the first part of next year. If we get those extra orders shipped, it will increase this year's earnings and also increase our current assets.

The vice president in charge of production commented:

We can ship every order we have now and every order we get during December before the close of business on December 31. We'll have to pay some overtime in our shipping department, but we'll try not to have a single unshipped order on hand at year-end. Also, we could overship some orders, and the customers wouldn't make returns until January.

The controller spoke next:

If there are late December orders from customers that we can't actually ship, we can just label the merchandise as sold and bill the customers with December 31 sales invoices. Also, there are always some checks from customers dated December 31 that don't reach us until January—some as late as January 10. We can record all those customers' checks bearing dates of late December as part of our December 31 cash balance.

The treasurer offered the following suggestions:

I owe the company \$50,000 on a call note I issued to buy some of our stock. I can borrow \$50,000 from my mother-in-law about Christmas time and repay my note to the company. However, I'll have to borrow the money from the company again early in January because my mother-in-law is buying a condo and will need the \$50,000 back by January 15.

Another thing we can do to improve our current ratio is to write checks on December 31 to pay most of our current liabilities. We might even wait to mail the checks for a few days or mail them to the wrong addresses. That will give time for the January cash receipts to cover the December 31 checks.

The vice president of production made two final suggestions:

Some of our inventory, which we had tentatively identified as obsolete, does not represent an open-and-shut case of being unsalable. We could defer any write-down until next year. Another item is some machinery we have ordered for delivery in December. We could instruct the manufacturer not to ship the machines and not to bill us before January.

After listening to these suggestions, the president, James Minor, spoke directly to Rand and Brink, the auditors.

You can see I'm doing my best to give you full information and cooperation. If any of these suggested actions would prevent you from giving a clean bill of health to our year-end statements, I want to know about it now so we can avoid doing anything that would keep you from issuing an unqualified audit report. I know you'll be doing a lot of preliminary work here before December 31, but I'd like for you not to bill us before January. Will you please give us your reactions as to what has been said in this meeting?

- Put yourself in the role of Rand & Brink, CPAs, and evaluate *separately* each suggestion made in the meeting. What general term is applicable to most of the suggested actions?
- Could you assure the client that an unqualified audit report would be issued if your recommendations were followed on all the matters discussed? Explain.
- Would the discussion in this meeting cause you to withdraw from the engagement?

Ethics Case



- 10–54. Today you had lunch with your friend Sarah Teasdale. Sarah has worked with Zaird & Associates, CPAs, for about two years. You’ve been with Zaird for only nine months. You discussed with her your difficulties in getting jobs done in the budgeted number of hours. Sarah said, “Yeah, that’s a problem. You’ll get quicker with experience, but—don’t tell anyone I told you this—some of those audit plans are pretty awful and include some pretty outdated and even some stupid procedures. Sometimes I just sign the plan, but skip doing the procedure. I don’t do this often, but sometimes the procedure isn’t capable of detecting anything.” You said little to her after this but are now thinking about whether you need to become more “practical” about how you perform your work.
- Identify your problem here.
 - Identify your possible courses of action. For each of these courses, identify any constraints relating to the decision (e.g., personal standards, societal norms, professional ethical standards, other professional standards) and analyze the course of action’s likely effects.
 - Select the best course of action.

Accounts Receivable, Notes Receivable, and Revenue

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 11-1** Describe the nature of receivables.
- LO 11-2** Describe the auditors' objectives in the audit of receivables and revenue.
- LO 11-3** Describe the documents, records, and accounts that compose the revenue (sales) transactions cycle and the fundamental controls over receivables and revenue.
- LO 11-4** Use the understanding of the client and its environment to consider inherent risks (including fraud risks) related to receivables and revenue.
- LO 11-5** Obtain an understanding of internal control over receivables and revenue.
- LO 11-6** Assess the risks of material misstatement of receivables and revenue and design further audit procedures, including tests of controls and substantive procedures, to address the risks.

This chapter describes the audit of receivables and revenue, both products of the revenue cycle. In broad terms, this cycle includes receiving orders from customers, providing and billing merchandise or services to customers, and recording and collecting accounts receivable. Receivables from customers include both accounts receivable and various types of notes receivable.

Receivables and Revenue

Sources and Nature of Accounts Receivable

LO 11-1

Describe the nature of receivables.

The vast majority of a company's accounts receivable are trade receivables that arise from credit sales of goods or services to customers. Trade notes and accounts receivable usually are relatively large in amount and should appear as separate items in the current assets section of the balance sheet at their net realizable value. Accounts receivable also include a variety of miscellaneous claims such as loans to officers, loans to subsidiaries, claims against other firms, claims for tax refunds, and advances to suppliers. Auditors are especially concerned with the presentation and disclosure of loans to officers, directors, and affiliated companies. These related party transactions are commonly made for the convenience of the borrower rather than to benefit the lending company. Consequently, such loans are often collected only at the convenience of the borrower. It is a basic tenet of financial statement presentation that transactions not characterized by arm's-length bargaining should be fully disclosed.

Sources and Nature of Notes Receivable

Notes receivable are written promises to pay certain amounts at future dates. Typically, notes receivable are used for handling transactions of substantial amount; these negotiable documents are widely used. In banks and other financial institutions, notes receivable usually constitute the single most important asset.

An installment note or contract may be used in an exchange that grants possession of goods to a purchaser but permits the seller to retain a lien on the goods until the final installment under the note has been received. Installment notes are widely used in the sale of industrial machinery, farm equipment, and automobiles. Other transactions that may lead to the acquisition of notes receivable include the disposal of items of plant and equipment; the sale of divisions of a company; the issuance of capital stock; and the making of loans to officers, employees, and affiliated companies.

The Auditors' Objectives in Auditing Receivables and Revenue

LO 11-2

Describe the auditors' objectives in the audit of receivables and revenue.

The auditors' *objectives* in the audit of receivables and revenue are to

1. Use the understanding of the client and its environment to consider *inherent risks*, including fraud risks, related to receivables and revenue.
2. Obtain an understanding of *internal control* over receivables and revenue.
3. Assess the risks of material misstatement and design tests of controls and substantive procedures that
 - a. Substantiate the *existence* of receivables and the *occurrence* of revenue transactions.
 - b. Establish the *completeness* of receivables and revenue transactions.
 - c. Verify the *cutoff* of revenue transactions.
 - d. Determine that the client has *rights* to recorded receivables.
 - e. Establish the proper *valuation* of receivables and the *accuracy* of revenue transactions.
 - f. Determine that the *presentation* and *disclosure* of information about receivables and revenue are appropriate, including the *classification* of receivables into appropriate categories, adequate reporting of any receivables pledged as collateral, and disclosure of related party sales and receivables.

Because of the close relationship between revenue and accounts receivable, the two can best be considered jointly. The determination of the amount of revenue to be recognized for a particular period is integrally related to a number of financial statement accounts, including sales and accounts receivable, adjustments to sales and accounts receivable, service revenue, deferred revenues, and cash. In addition, it is a major determinant of the amount of net income that the company reports for a particular period. Therefore, the audit of revenue and receivables is an area of high risk to auditors.

Internal Control of Accounts Receivable and Revenue

To understand internal control over accounts receivable and revenue, the auditors should consider the various components, including the control environment, risk assessment, monitoring, the (accounting) information and communication system, and control activities.

Control Environment

Because of the risk of intentional misstatement of revenues, the control environment is very important to effective internal control over revenue and receivables. Of particular importance is an effective board of directors (and audit committee) that provides effective oversight of management's judgments about revenue recognition principles and estimates, as well as an effective internal audit function. Management should establish a *tone at the top* of the organization that encourages integrity and ethical financial reporting. These ethical standards should be communicated and observed throughout the organization. Also, incentives for dishonest reporting, such as undue emphasis on meeting unrealistic sales or earnings targets, should be eliminated.

Appropriate revenue recognition may involve complex accounting principles, estimates, and computations. As a result, management should make a *commitment to competence*, especially as it relates to key financial and accounting personnel. Increased control is indicated when management effectively identifies the skills and training needed to perform key functions and implements effective procedures to ensure that these functions are performed by competent personnel.

Management's commitment to integrity and ethical values, as indicated by its attitude toward financial reporting, is also important in the control of revenue and receivables. The relevant questions include: Is management aggressive or conservative in selecting methods of revenue recognition? Are estimates of uncollectible accounts developed in a conscientious manner?

With regard to its commitment to attract, develop, and retain competent employees, management should make appropriate background checks of prospective employees and obtain **fidelity bonds** on employees in positions of trust. Individuals with significant



Illustrative Case

Fraudulent Revenue Recognition

An analysis of SEC enforcement cases involving fraud reported that of the 347 companies reporting fraud, 61 percent involved improper revenue recognition.¹ The improper revenue recognition techniques

included sham (fictitious) sales, conditional sales, recording of loans as sales, recording of revenue before the recognition criteria were met, improper cutoff, unauthorized shipments, and recording of consignment shipments as sales.

control responsibilities must be competent to perform their assigned duties. Internal control is also improved when individuals who maintain accounting records or cash are required to take vacations and when their assigned duties are rotated periodically.

Risk Assessment

As discussed in Chapter 7, risk assessment involves identification, analysis, and management of risks relevant to achieving the organization's objectives. In relation to the revenue cycle, management should develop a formal process of monitoring external factors, such as changes in economic conditions, competition, customer demand, and regulations that may affect the risk of achieving the company's sales objectives. In addition, management should evaluate the effects of internal factors, such as changes in accounting principles, the introduction of new products and services, and the use of new types of sales contracts. These internal and external factors may create new risks for the company, indicating a need to implement new types of controls to prevent the misstatement of revenue.

Revenue Cycle— Accounting System and Control Activities

LO 11-3

Describe the documents, records, and accounts that compose the revenue (sales) transactions cycle and the fundamental controls over receivables and revenue.

For many companies, the primary source of revenue is from the sale of goods or services to customers on credit. Ineffective controls over credit sales and receivables can be costly to a business. When control activities over sales on account are inadequate, large credit losses are almost inevitable. For example, merchandise may be shipped to customers whose credit standing has not been approved. Shipments may be made to customers without notice being given to the billing department; consequently, no sales invoice is prepared. Sales invoices may contain errors in prices and quantities; and if sales invoices are not controlled, some may be lost and never recorded as accounts receivable. To avoid such difficulties, strong controls over credit sales are necessary. Usually, internal control over credit sales is strengthened by a division of duties so that different departments or individuals are responsible for (1) preparation of the sales order, (2) credit approval, (3) issuance of merchandise from stock, (4) shipment, (5) billing, (6) invoice verification, (7) maintenance of control accounts, (8) maintenance of customers' ledgers, (9) approval of sales returns and allowances, and (10) authorization of write-offs of uncollectible accounts. When this degree of subdivision of duties is feasible, accidental errors are likely to be detected quickly through the comparison of documents and amounts emerging from independent units of the company, and the opportunity for fraud is reduced to a minimum. While our discussion of the accounting system and control activities will be developed primarily in terms of the sales processes of manufacturing companies, most of the principles also apply to service organizations.

Controlling Customers' Orders

The controlling and processing of orders received from customers require carefully designed operating procedures and numerous controls if costly errors are to be avoided.

¹ Mark Beasley, Joseph Carcello, Dana Hermanson, and Terry Neal, "Fraudulent Financial Reporting: 1998–2007—An Analysis of U.S. Public Companies (2010)," Committee of Sponsoring Organizations of the Treadway Commission (COSO).

78644			
PURCHASE ORDER Pilot Stores 1425 G St. Irvine, CA 92345			
To: Wood Supply Co.		Date: Nov. 10, 20X0	
21 Main St.		Ship via: Jon Trucking	
Suisun, CA 95483		Terms: 2/10, n/40	
Enter our order for			
Qty.	Description	Price	Total
20 doz.	Q Clamps #26537489	\$235.00	\$4700.00
10	120 hp Generators #45983748	355.00	3550.00
Wood Supply Co. By <u>Bill Jones</u>			

476538		
SALES ORDER Wood Supply Co. 21 Main St. Suisun, CA 95483		
To: Pilot Stores		Date: Nov. 23, 20X0
1425 G St.		Credit Approval: <u>MS</u>
Irvine, CA 92345		
Cust. No.: 12654		
Description	Part No.	Quantity
Q Clamps	26537489	20 doz.
120 hp Generators	45983748	10

Important initial steps include registering the customer's *purchase order*, reviewing items and quantities to determine whether the order can be filled within a reasonable time, and preparing a *sales order* (see below). The sales order is a translation of the terms of the customer's order into a set of specific instructions for the guidance of various divisions, including the credit, finished goods stores, shipping, billing, and accounts receivable units. The action to be taken by the factory upon receipt of a sales order will depend upon whether the goods are standard products carried in stock or are to be produced to specifications set by the customer.

Credit Approval

Before sales orders for new or unapproved customers are processed, the credit department must determine whether goods may be shipped to the customer on open account. This department is supervised by a credit manager who reports to the treasurer or the vice president of finance. The credit department implements management's credit policies and uses them to evaluate prospective and continuing customers by studying the customer's financial statements and by referring to reports of credit agencies, such as Dun & Bradstreet Inc. Once a new customer has been granted a line of credit, approval of a particular sales transaction involves a simple determination of whether the customer has sufficient unused credit. This process is often performed by the IT system. If the sales transaction will cause the customer's credit limit to be exceeded, the computer will alert the credit department, which will initiate the process of determining whether to increase the customer's line of credit. When credit is not approved, the customer is notified and an effort is made to negotiate other terms, such as cash on delivery.

Issuing Merchandise

Companies that carry standard products in stock maintain a finished goods storeroom supervised by a storekeeper. The storekeeper issues the goods covered by a sales order to the shipping department only after the sales order has been approved by the credit department. Perpetual inventory records of finished goods should be maintained by the accounting department, not by the storekeeper.

The Shipping Function

When the goods are transmitted by the finished goods storeroom to the shipping department, this group must arrange for space in railroad cars, aircraft, or motor freight carriers.

10026574		
BILL OF LADING		
Wood Supply Co. 21 Main St. Suisun, CA 95483		
		Date: <u>Nov. 25, 20X0</u>
Shipped to:		Order No: <u>476538</u>
Pilot Stores <u>1425 G St.</u> <u>Irvine, CA 92345</u>		Shipper: <u>Jon Trucking</u>
Quantity	Description	Weight
5 Boxes	20 doz. Q Clamps #26537489	142
10 Crates	10 hp Generators #45983748	2560
		2702
Shipper's Acceptance: Bill Warren		

7462537			
SALES INVOICE			
Wood Supply Co. 21 Main St. Suisun, CA 95483			
		Date: <u>Nov. 27, 20X0</u>	
Sold to: Pilot Stores		Your order no. <u>78644</u>	
<u>1425 G St.</u>			
<u>Irvine, CA 92345</u>			
		Shipped: <u>Nov. 25, 20X0</u>	
		Shipped via: <u>Jon Trucking</u>	
		Terms: <u>2/10, n/40</u>	
Qty.	Description	Price	Total
20 doz.	Q Clamps	\$235.00	\$ 4700.00
10	120 hp Generators	355.00	3550.00
			\$ 8250.00

Shipping documents, such as *bills of lading* (see below), are created at the time of loading the goods into cars or trucks. The shipping documents are numerically controlled and are entered in a shipping register before being forwarded manually or electronically to the billing department. When shipments are made by truck, some type of gate control also is needed to ensure that all goods leaving the plant have been recorded as shipments. This may require the surrender to the gatekeeper of copies of shipping documents.

The Billing Function

The term *billing* means notifying the customer of the amount due for goods or services delivered. This notification is accomplished by preparing and mailing a *sales invoice* (see above) in either electronic or paper form. A department not under the control of sales executives should perform billing. The function is generally assigned to a separate section within the accounting, data processing, or finance department. If a manual process is used, the billing section has the responsibility of (1) accounting for the serially numbered shipping documents, (2) comparing shipping documents with sales orders and customers' purchase orders and change notices, (3) entering pertinent data from these documents on the sales invoice, (4) applying prices and discounts from price lists to the invoice, (5) making the necessary extensions and footings, and (6) accumulating the total amounts billed. When a formal contract exists, accounting personnel must carefully consider the contract terms and the relevant accounting standards.

Under FASB ASC 606, revenue should be recognized when contract performance obligations are met and it is probable that the portion of the contract price allocated to the performance obligation is collectible. Once appropriate revenue recognition principles are adopted, it is important for management to determine that it carefully considers any changes in terms that might affect the method of revenue recognition. Standard contracts should be adopted and employees should not be able to make changes in terms without management approval.

Sales invoices are usually generated by the IT system based upon information that has already been entered into the system. Shipping department personnel input information about the quantities of goods shipped, and prices to be charged either have been entered by personnel in the sales department when the sales order was generated or are contained in a master file of authorized sales prices. As the sales invoices are printed, the IT system also creates an electronic sales transactions file that is used in conjunction with the cash

receipts transactions file to update the master file of accounts receivable. Periodically, the IT system updates the general ledger and prints the sales journal and the subsidiary ledger of accounts receivable. The computer also generates monthly statements for mailing to customers.

Controls should be established to ensure the accuracy of the invoices before they are mailed to customers. When a portion of the accounting system relies on manual operations, these controls might consist of a second-person review of the accuracy of prices, credit terms, transportation charges, extensions, and footings. When an IT-based billing system is in use, this objective is generally achieved by implementing input validation (edit) checks and various processing controls.

Collection of Receivables

Receivables held by companies are collected by receipt of customers' checks and remittance advices through the mail or electronically.² The cashier will control and deposit checks. The remittance advices or a listing of the receipts will then be forwarded to the accounts receivable section of the data processing department, which will record them in the appropriate accounts in the customers' ledger. The total reduction in accounts receivable will be posted periodically to the general ledger control account from the total of the accounts receivable column in the cash receipts journal. Internal control over collections from customers is shown in the cash receipt flowchart in Figure 10.1 of Chapter 10.

An *aged trial balance* of customers' accounts should be prepared at regular intervals for use by the credit department in carrying out its collection program. This schedule will also aid the company in its determination of an appropriate allowance for doubtful accounts.

Controls over Revenue Estimates

When amounts of revenue must be estimated because of the complexity of the agreements or difficulties in determining the portion of the revenue earned, the client should establish effective controls over the development of the estimates, including

1. Control environment policies and procedures that encourage proper estimates.
2. Risk assessment policies that consider the risks of inappropriate selection or application of revenue recognition principles.
3. Policies that ensure that competent personnel are involved in developing the revenue estimates, including those that have an understanding of revenue recognition accounting standards, contract terms, characteristics of customers, and economic conditions.
4. Policies and procedures that ensure that relevant, sufficient, and reliable data are considered in the development of the revenue estimates.
5. Management review and approval of sources of data, processes used to develop the assumptions, changes in the methods used, and the reasonableness of assumptions and revenue estimates.
6. Policies to improve estimation processes by comparison of prior revenue estimates with actual revenue realized.

Adjustments to Sales and Receivables

All adjustments to sales for allowances, returns, and write-offs of accounts receivable should be supported by serially numbered *credit memoranda* (see below) signed by an officer or responsible employee having no duties relating to cash handling or to the maintenance of customers' ledgers. Good internal control over credits for returned merchandise usually includes a requirement that the goods be received and examined before credit is given. The credit memoranda should then bear the serial number of the receiving report on the returned shipment.

² Chapter 10 provides information on cash receipts directly by financial institutions (e.g., lockbox systems, debit and credit card sales proceeds, and other electronic receipts).

No. 4584	
CREDIT MEMORANDUM Wood Supply Co. 21 Main St. Suisun, CA 95483	
Customer: <u>Howe Carpet Co.</u> <u>894 Reed St.</u> <u>Orange, CA 92786</u>	Date: <u>Dec. 15, 20X0</u>
Customer No.: <u>687960</u> Receiving Report No.: <u>N/A</u>	Invoice No. <u>7598597</u>
Description	Amount
Allowance for substandard goods	\$550.00
Authorized by: Janis Morris	

The credit manager should initiate the process of uncollectible receivable write-off, with subsequent authorization by the treasurer. Receivables that are written off should then be either turned over to a collection agency or retained and transferred to a separate ledger and control account. The records may be of a memorandum nature rather than part of the regular accounting system. Also, when possible—generally when the debtor is still in existence—statements requesting payment should continue to be mailed. Otherwise, any subsequent collections may be embezzled by employees without the necessity of falsifying records to conceal the theft.

The division of responsibility, sequence of procedures, and basic documentation of the handling of credit sales transactions are illustrated in the systems flowchart in Figure 11.1.

Monitoring

A major type of monitoring controls for revenue and receivables is **management review controls**. Appropriate controls here involve reviewing various types of performance reports, such as sales and gross margin by product line, by major customer, by geographic area, and by salesperson. In addition, management often will carefully review the aging of accounts receivable and may solicit feedback from customers about the accuracy of billings. Data analytics software also may be used to identify unusual transactions or relationships, such as comparably large transactions occurring near period end. When unexpected amounts or unusual transactions are discovered, management should follow up to determine the underlying reasons.

Internal auditors also contribute to the monitoring process. As a part of their audit activities, they may periodically take over the mailing of monthly statements to customers, or send confirmations and investigate discrepancies reported. They also may perform extensive reviews of shipping reports, invoices, cash receipts, credit memoranda, and the aged trial balances of accounts receivable to determine whether prescribed control activities are being carried out consistently. In addition, reports of regulatory agencies should be considered in making improvements in internal control. Increasingly, internal auditors are also using data analytics to continuously monitor controls. Unusual transactions, entries, or other items are selected by the software based on the internal auditors' criteria. Then, the internal auditors investigate these items to determine whether they represent misstatements or situations in which other controls have broken down.

Internal Control over Notes Receivable

As previously stated, a basic characteristic of effective control consists of the subdivision of duties. As applied to notes receivable, this principle requires that

- The custodian of notes receivable not have access to cash or to the general accounting records.
- The acceptance and renewal of notes be authorized in writing by a responsible official who does not have custody of the notes.
- The write-off of defaulted notes be approved in writing by responsible officials and effective procedures adopted for subsequent follow-up of such defaulted notes.

These rules are obviously corollaries of the general proposition that the authorization, recording, and custodial functions should be separate, especially for cash and receivables.

If the acceptance of a note from a customer requires written approval of a responsible official, the likelihood of fictitious notes being created to offset a theft of cash is significantly reduced. The same review and approval should be required for renewal of a note; otherwise, an opportunity to hide the diversion of the proceeds of a paid note exists through the perpetrator's recording it as having been renewed. The protection provided by this procedure of requiring executive approval of notes will be stronger if the internal auditing department periodically confirms notes directly with the makers.

The abstraction of cash receipts is sometimes concealed by failing to make an entry to record receipt of a partial payment on a note. Satisfactory control over the recording of partial payments requires that the date and amount of the payment and the new unpaid balance should be recorded and maintained by the accounting system. Notes written off as uncollectible should be kept under accounting control because occasionally debtors may attempt to reestablish their credit in later years by paying old dishonored notes. Any credit memoranda or journal vouchers for partial payments, write-offs, or adjustment of disputed notes should be authorized by proper officials and kept under numerical control.

Adequate controls over notes receivable secured by mortgages and trust deeds must include follow-up procedures that assure prompt action on delinquent property taxes and insurance premiums, as well as nonpayment of interest and principal installments.

In many companies, internal control is strengthened by the preparation of monthly reports summarizing notes receivable transactions during the month and the details of notes owned at the end of the reporting period. These reports are often designed to focus executive attention immediately upon any delinquent notes and to require advance approval for renewals of maturing notes. In addition, a monthly report on notes receivable ordinarily will show the amounts collected during the month, the new notes accepted, notes discounted, and interest earned. The person responsible for reporting on note transactions should be someone other than the custodian of the notes.

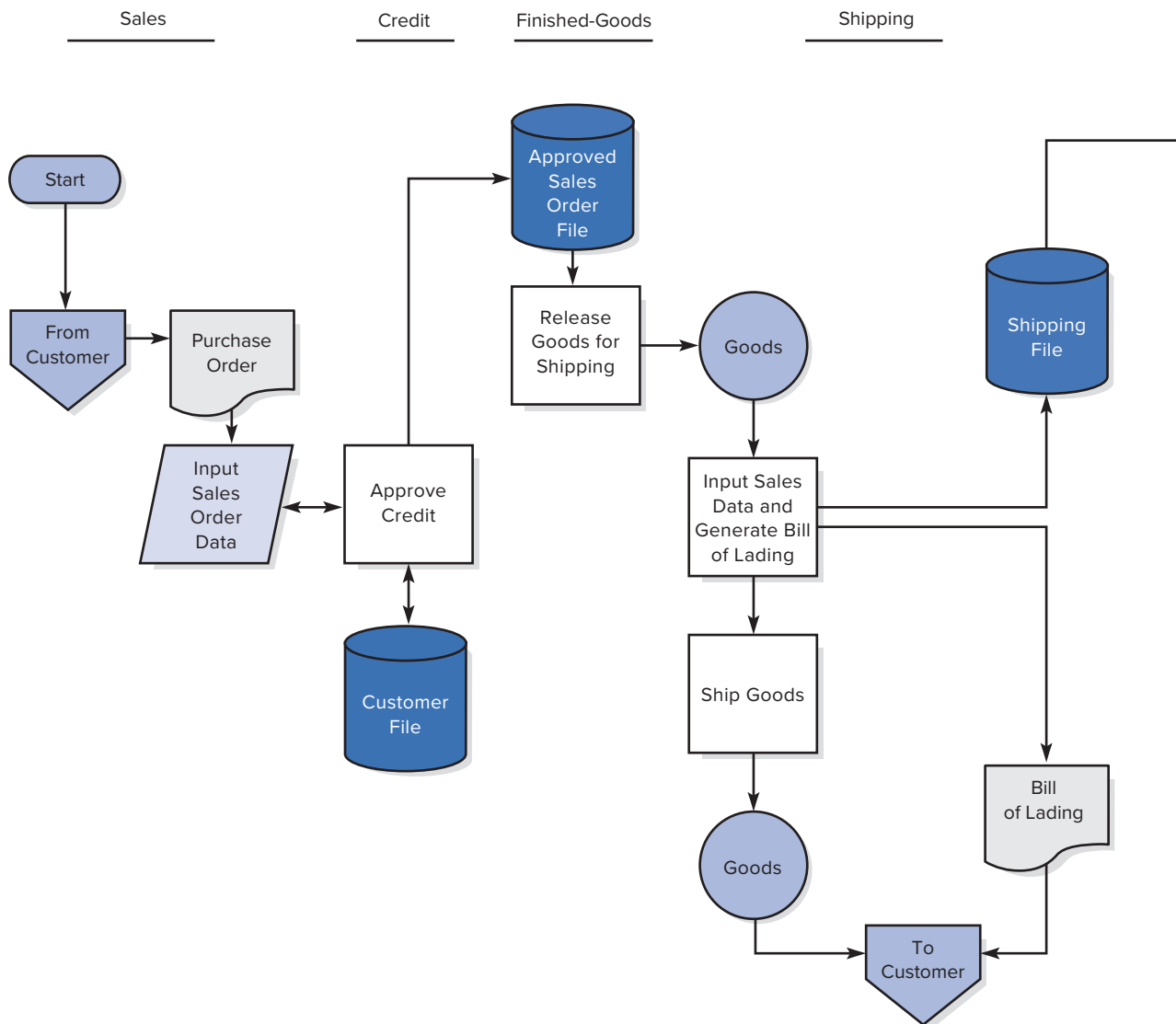
Audit Documentation for Receivables and Revenue

Besides preparing lead schedules for receivables and net revenue, the auditors obtain or prepare the following working papers:

1. Aged trial balance of trade accounts receivable (often a computer printout).
2. Analyses of other accounts receivable.
3. Analysis of notes receivable and related interest.
4. Analysis of allowance for uncollectible accounts and notes.
5. Comparative analyses of revenue by month, by product, by territory, or by relating forecasted revenue to actual revenue.
6. Documentation of internal controls.
7. Risk analyses and audit plan (program).

FIGURE 11.1 Dixieline Industries Ltd.: Credit Sales Systems Flowchart, December 31, 20X0

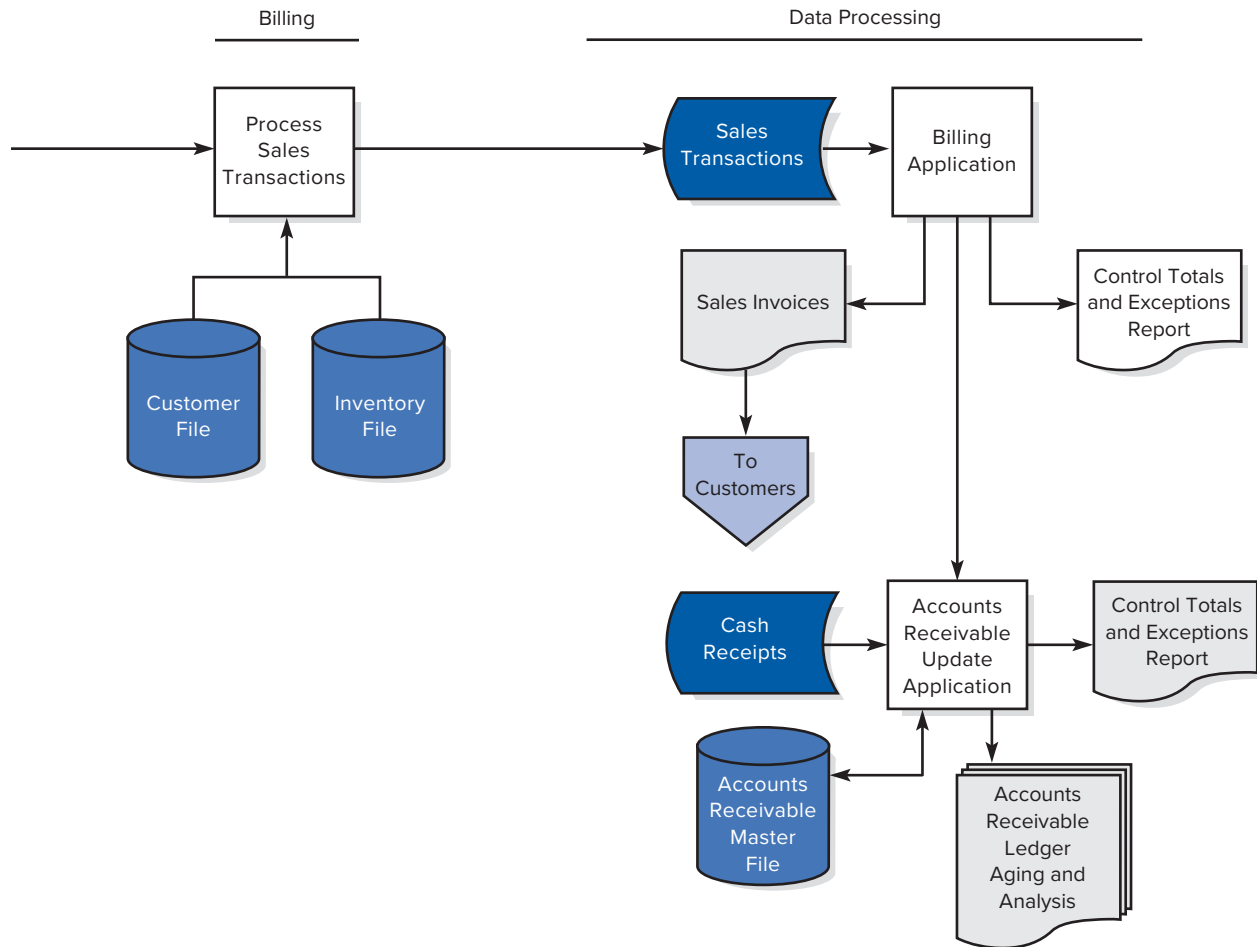
DIXIELINE INDUSTRIES LTD.
CREDIT SALES SYSTEMS FLOWCHART
DECEMBER 31, 20X0



Audit of Receivables and Revenue

The following steps indicate the general pattern of work performed by the auditors in the verification of receivables and revenue. Selection of the most appropriate procedures for a particular audit will be guided by the nature of the internal controls that have been implemented and by the results of the auditors' risk assessments.

- A. Use the understanding of the client and its environment to consider inherent risks, including fraud risks, related to receivables and revenue.
- B. Obtain an understanding of internal control over receivables and revenue.
- C. Assess the risks of material misstatement and design further audit procedures.
- D. Perform further audit procedures—tests of controls.
 1. Examples of tests of controls:
 - a. Test the controls over sales transactions by examining the process of recording the transactions.
 - b. Trace details of shipping documents to related sales invoices.



- c. Review the use and authorization of credit memoranda.
 - d. Test controls for over-the-counter sales by reconciling cash register records or sales tickets with sales journals.
 - e. Test management review controls.
 - f. Test controls over estimates related to revenues and receivables.
2. If necessary, revise the risks of material misstatement based on the results of tests of controls.
- E. Perform further audit procedures—substantive procedures for receivables and revenue.
1. Obtain an *aged trial balance* of trade accounts receivable and analyses of other accounts receivable and reconcile to ledgers.
 2. Obtain analyses of notes receivable and related interest and reconcile to the general ledger.
 3. Inspect notes on hand and confirm those with holders.
 4. Confirm receivables with debtors.
 5. Perform analytical procedures for accounts receivable, notes receivable, and revenue.
 6. Review significant year-end sales contracts for unusual terms.

7. Review the year-end cutoff of sales transactions.
8. Test the valuation of notes receivable, computation of interest income, interest receivable, and amortization of discount or premium.
9. Evaluate the propriety of the client's accounting methods for receivables and revenue.
10. Evaluate accounting estimates related to revenue and receivables.
11. Determine the adequacy of the client's allowance for uncollectible accounts.
12. Ascertain whether any receivables have been pledged.
13. Investigate any transactions with or receivables from related parties.
14. Evaluate the business purpose of significant and unusual sales transactions.
15. Evaluate financial statement presentation and disclosure of receivables and revenue.

Figure 11.2 relates these major substantive procedures for receivables and revenue to their primary audit objectives.

As discussed in Chapter 6, it is essential for the auditors to have a thorough understanding of the client's business and the industry in which it operates. Regarding revenue and receivables, this understanding includes matters such as

- The types of products and services sold.
- The classes and categories of the client's customers.
- Whether the business is affected by seasonal or cyclical demand.
- Level of competition in the industry.
- Typical marketing policies for the client and its industry.
- Contract terms, including pricing, sales returns, discounts, extension of credit, and normal delivery and payment terms.
- Compensation arrangements that are based on recorded revenue.
- Typical revenue recognition principles used in the industry and their methods of application.

An understanding of these matters helps ensure that the auditors effectively execute the audit plan for receivables and revenue.

FIGURE 11.2 Objectives of Major Substantive Procedures for Receivables and Revenue

Substantive Procedures	Primary Audit Objectives
Obtain aged listing of receivables and reconcile to ledgers. Obtain analyses of notes receivable and related interest.	<i>Valuation and accuracy</i>
Inspect notes on hand and confirm those not on hand.	<i>Existence, occurrence, and rights</i>
Confirm receivables with debtors.	<i>Existence, occurrence, and rights</i> <i>Valuation and accuracy</i>
Perform analytical procedures or data analytics. Review significant year-end sales contracts.	<i>Existence, occurrence, and rights</i> <i>Cutoff</i> <i>Valuation and accuracy</i>
Review the year-end cutoff of sales transactions.	<i>Cutoff</i>
Verify interest earned on notes receivable.	<i>Completeness</i>
Evaluate the propriety of client's accounting for transactions. Evaluate accounting estimates related to revenues and receivables.	<i>Valuation and accuracy</i>
Determine adequacy of allowance for uncollectible accounts.	<i>Valuation</i>
Ascertain the existence of pledged receivables. Investigate receivables from related parties.	<i>Presentation and disclosure</i>
Evaluate the business purpose of significant and unusual sales transactions.	<i>Valuation and accuracy</i> <i>Presentation and disclosure</i>
Evaluate financial statement presentation and disclosure.	<i>Presentation and disclosure</i>



Illustrative Case

Typical Case of Fraudulent Revenue Recognition



The case of California Micro Devices Corp. is typical of situations involving management misstatement of revenue. In this case, management had no revenue recognition policies and significantly overstated revenue using a number of techniques, including

- Recording revenue on products that were not yet shipped or even ordered.

- Failing to decrease revenue for returned products.
- Paying distributors “handling fees” to accept shipments of products for which they had unlimited rights of return and booking the shipments as sales.

It was reported that, at the peak of the fraud, as much as 70 percent of total sales was in the “fake” category.

LO 11-4

Use the understanding of the client and its environment to consider inherent risks (including fraud risks) related to receivables and revenue.

A. Use the Understanding of the Client and Its Environment to Consider Inherent Risks, Including Fraud Risks, Related to Receivables and Revenue.

The auditors use their understanding of the client’s environment to assess the inherent risks for the assertions about receivables and revenue. The auditors face a number of potential inherent risks related to receivables and revenue. Most of these risks are derived from business risks that are faced by management, such as the risks of

- A decline in sales due to economic declines, product obsolescence, increased competition, or shifts in product or service demand.
- Inability to collect receivables.
- Improper revenue recognition (either intentionally or unintentionally).
- Restrictions placed on sales by laws and regulations.

Risks of material misstatement also arise from the possibility of fraud. Improper revenue recognition has been the most common technique used by management to engage in fraudulent financial reporting. Therefore, the audit of revenue and receivables is often an area of **significant risk** to auditors. This is so much so that the professional standards indicate that the auditors should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition.

Because material misstatement related to revenue recognition is normally a fraud risk, the auditors will make sure that they understand the controls established by management to control this risk. They also will determine whether the controls have been implemented. Finally, the auditors will design their responses to the risks. As discussed in Chapter 6, the auditors’ responses may take one or more of the following forms:

1. A response that has an overall effect on how the audit is conducted. For example, the auditors might assign personnel with significant experience in the client’s industry to evaluate the accounting principles used to recognize revenue.
2. A response involving the design of audit procedures. For example, the auditors might require the confirmation of accounts receivable to be performed at year-end as opposed to an interim date.
3. A response involving performing procedures to further address the risk of material misstatement due to management’s override of internal control. For example, the auditors will evaluate particularly carefully the business purpose of any unusual and significant sales transactions that they encounter, and they will evaluate the allowance for uncollectible accounts for evidence of management bias.

LO 11-5

Obtain an understanding of internal control over receivables and revenue.

B. Obtain an Understanding of Internal Control over Receivables and Revenue.

The auditors’ consideration of controls over receivables and revenue may begin with the preparation of a written narrative description or flowchart and the completion of an internal control questionnaire. Typical of the questions comprising an internal control



Illustrative Case

Responding to a Significant Risk Related to Revenue Recognition

The following excerpt from PricewaterhouseCoopers LLP's audit report for Cisco

Systems Inc. describes an aspect of revenue recognition as a **critical audit matter (CAM)**. The excerpt illustrates how auditors respond to a significant risk related to revenue recognition.

CRITICAL AUDIT MATTER

Revenue recognition—identification of contractual terms in certain customer arrangements

As described in Note 2 to the consolidated financial statements, management assesses relevant contractual terms in its customer arrangements to determine the transaction price and recognizes revenue upon transfer of control of the promised goods or services in an amount that reflects the consideration the Company expects to receive in exchange for those products or services. Management applies judgment in determining the transaction price which is dependent on the contractual terms. In order to determine the transaction price, management may be required to estimate variable consideration when determining the amount and timing of revenue recognition.

The principal considerations for our determination that performing procedures relating to the identification of contractual terms in customer arrangements to determine the transaction price is a critical audit matter are there was significant

judgment by management in identifying contractual terms due to the volume and customized nature of the Company's customer arrangements. This in turn led to significant effort in performing our audit procedures which were designed to evaluate whether the contractual terms used in the determination of the transaction price and the timing of revenue recognition were appropriately identified and determined by management and to evaluate the reasonableness of management's estimates.

Addressing the matter involved performing procedures and evaluating audit evidence in connection with forming our overall opinion on the consolidated financial statements. These procedures included testing the effectiveness of controls relating to the revenue recognition process, including those related to the identification of contractual terms in customer arrangements that impact the determination of the transaction price and revenue recognition. These procedures also included, among others: (i) testing the completeness and accuracy of management's identification of the contractual terms by examining customer arrangements on a test basis, and (ii) testing management's process for determining the appropriate amount and timing of revenue recognition based on the contractual terms identified in the customer arrangements.

Auditor reporting on critical audit matters was introduced in Chapter 2 and is discussed in detail in Chapter 17.

questionnaire for revenue and receivables are the following: Are orders from customers initiated and reviewed by the sales department? Are sales invoices prenumbered and all numbers accounted for? Are all sales approved by the credit department before shipment? Are estimates of revenue performed by competent personnel using appropriate methods?

After the auditors have prepared a description of the controls, they will determine whether the client is actually using the policies and procedures—that is, whether they have been *implemented*. As the auditors confirm their understanding of the revenue cycle, they will observe whether there is an appropriate segregation of duties and inquire as to who performed various functions throughout the year. They also will review revenue budgets and the follow-up on the variances; perform a walk-through of the cycle; inspect various documents, such as bills of lading, sales invoices, and customer statements; and review document files to determine that the client is appropriately accounting for the sequence of prenumbered documents. Figure 11.3 illustrates these documents and the primary accounts involved in the revenue cycle.

LO 11-6

Assess the risks of material misstatement of receivables and revenue and design further audit procedures, including tests of controls and substantive procedures, to address the risks.

C. Assess the Risks of Material Misstatement and Design Further Audit Procedures.

After considering the information about the client and its environment, including internal control over receivables and revenues, the auditors identify and assess the **risks of material misstatement** at the financial statement and assertion levels. At the financial statement level, they assess whether identified risks have (1) a pervasive effect on the financial statements and require an overall response and (2) effects on individual financial statement assertions. At the assertion level, the auditors identify **relevant assertions** and design appropriate further audit procedures in response. If additional evidence on the effectiveness of the controls is needed to support these assessed levels, the auditors will design additional tests of control. In designing these tests, the auditors must decide

which will result in sufficient reductions in substantive procedures to justify the time spent performing them. This entire process is described in detail in Chapter 6.

By considering these risk assessments, the auditors are able to identify “what could go wrong” to cause receivables and revenues to be materially misstated. Figure 11.4 provides examples of potential misstatements of revenue and weaknesses in internal control that make them more likely to occur.

Some of the risks identified by the auditors will be considered significant risks that require special audit consideration. As an example, if the client executes complex sales contracts, there may be a significant risk of misstatement of sales revenue that requires specific audit tests. In this case, the auditors may decide to confirm the terms of contracts with the client’s customers. It is important to remember that for any significant risk, the auditors should

1. Evaluate the design of the related controls and determine that they are implemented.
2. Perform substantive procedures.³
3. Test the operating effectiveness of controls in the current period when they plan to rely on those controls.

D. Perform Further Audit Procedures—Tests of Controls.

Tests directed toward the effectiveness of controls help to evaluate the client’s internal control and determine whether the auditors’ planned assessed levels of control risk can be supported. Certain tests of controls are performed as the auditors obtain an understanding of the client’s internal control; these were described in our earlier discussion of that process.

1. Examples of Tests of Controls.

a. Test the controls over sales transactions by examining the process of recording the transactions.

To determine that the controls portrayed in the documentation are effectively functioning in everyday operations, the auditors may decide to examine significant aspects of a sample of sales transactions. The size of the sample and the transactions included therein may be determined by either statistical or nonstatistical sampling techniques. The auditors often use generalized computer audit software to select the transactions to be tested.

In manufacturing companies, the audit procedure for verification of a sales transaction that has been selected for testing may begin with a comparison of the customer’s purchase order, the client’s sales order, and the duplicate copy of the sales invoice. The descriptions and quantities of items are compared on these three documents and traced to the duplicate copy of the related shipping document. The credit manager’s signature denoting approval of the customer’s credit should appear on the sales order.

In a manual system, the extensions and footings on each invoice in the sample should be proved to be mathematically correct. In addition, the date of each invoice should be compared with two other dates: (1) the date on the related shipping document and (2) the date of entry in the accounts receivable subsidiary ledger.

Consistent pricing and sales discount policies are a necessary element of good internal control over sales transactions. After discussing the policies with management, the auditors can verify the prices and discounts on the invoices selected for testing by comparison with authorized price lists, catalogs, or contracts with customers. After proving the accuracy of selected individual invoices, the auditors next trace the invoices to the sales journal and to postings in the accounts receivable subsidiary ledger.

If the company has a well-controlled IT system, the auditors will have confidence that once accurately entered into the system, the transaction will be accurately reflected in the accounting records. If the general controls (e.g., access controls) are determined to be effective, the auditors will have confidence that sales transactions are authorized by appropriate sales personnel, approved by credit department personnel, and dispatched by

³ The PCAOB requires the performance of substantive procedures that include tests of details for all significant risks.

FIGURE 11.3 Overview of the Revenue and Cash Receipts Cycle—Documents and Accounts**Sales**

PURCHASE ORDER 78644			
Pilot Stores 1425 G St. Irvine, CA 92345			
To: <u>Wood Supply Co.</u>		Date: <u>Nov. 10, 20X0</u>	
<u>21 Main St.</u>			
<u>Suisun, CA 95483</u>		Ship via: <u>Jon Trucking</u>	
Terms: <u>2/10, n/40</u>			
Enter our order for			
Qty	Description	Price	Total
20 doz.	Q Clamps #26537489	\$235.00	\$4700.00
10	120 hp Generators #45983748	355.00	3550.00
Wood Supply Co. By: <u>Bill Jones</u>			

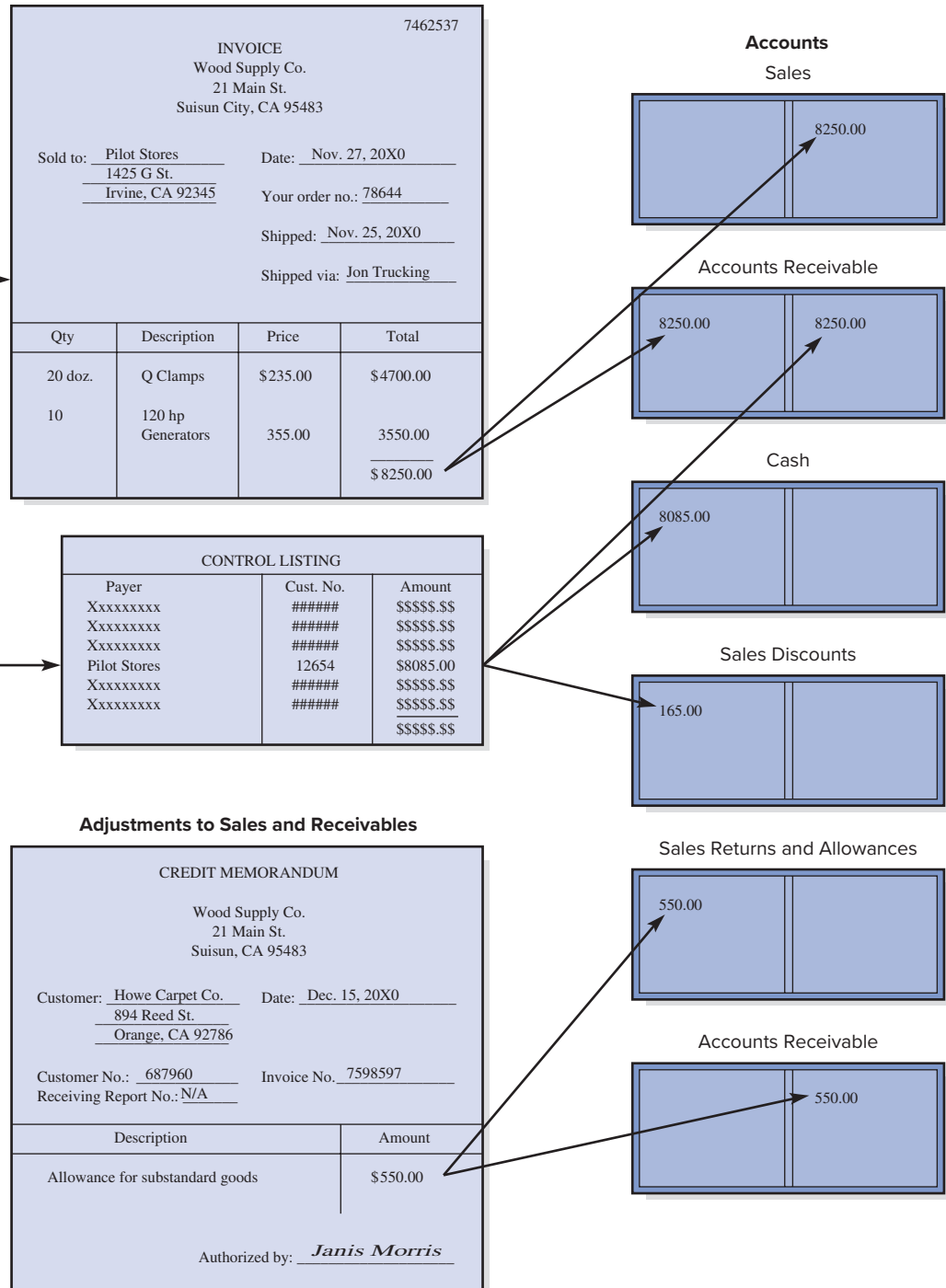
BILL OF LADING 10026574		
Wood Supply Co. 21 Main St. Suisun, CA 95483		
		Date: <u>Nov. 25, 20X0</u>
Shipped to:		Order No.: <u>476538</u>
<u>Pilot Stores</u>		
<u>1425 G St.</u>		Shipper: <u>Jon Trucking</u>
<u>Irvine, CA 92345</u>		
Quantity	Description	Weight
5 Boxes	20 doz. Q Clamps #26537489	142
10 Crates	10 hp Generators #45983748	2560
		2702
Shipper's Acceptance: <u>Bill Warren</u>		

SALES ORDER 476538		
Wood Supply Co. 21 Main St. Suisun City, CA 95483		
To: <u>Pilot Stores</u>		Date: <u>Nov. 23, 20X0</u>
<u>1425 G St.</u>		
<u>Irvine, CA 92345</u>		Credit Approval: <u>MS</u>
Cust. No.: <u>12654</u>		
Description	Part No.	Quantity
Q Clamps	26537489	20 doz.
120 hp Generators	45983748	10

Check Cash Receipts	
Pilot Stores 1425 G St. Irvine, CA 92345	
Date: <u>Dec. 5, 20X0</u>	
Pay to the order of <u>Wood Supply Co.</u>	<u>\$8085.00</u>
Eight thousand eighty-five and no/100	
First National Bank California	Pilot Stores <u>Jackie Cohen</u>
Remittance Advice	
Wood Supply Co.	
Inv. #7462537	\$8085.00

the shipping department. Tests of application controls might involve inspecting evidence of the operations control group's reconciliation of batch control totals for sales transactions, as well as the follow-up on any transactions that are listed on exception reports. The auditors might also observe the application of input validity tests as sales transactions are entered. They may also enter test data to obtain additional evidence about performance of application controls. Rather than test a sample of sales transactions, the auditors may decide to use data analytic techniques to determine that 100 percent of the sales transactions are authorized, approved, and supported by an electronic shipping document.

When performing tests of sales transactions, the auditors should be alert for indications of shipments of consigned items treated as sales. This may occur due to error or a policy of a company that disposes of only a small portion of its total output by consignment. In either case, such consignments do not represent valid sales; the auditors' response will depend upon the nature and significance of the transactions involved.



If the subsidiary records for receivables include some accounts with large debit entries and more numerous small credit entries, this should suggest to the auditors that goods have been shipped on consignment and that payments are being received only as the consignee makes sales. Notations such as “Consignment shipment” or “On approval” are sometimes found in subsidiary ledgers or on the duplicate copies of sales invoices. Numerous large returns of merchandise are also suggestive of consignment shipments.

**FIGURE 11.4** Potential Misstatements—Revenue

Description of Misstatement	Examples	Internal Control Weaknesses or Factors That Increase the Risk of the Misstatement
Recognizing revenue not yet earned	Fraud: - Recording fictitious sales without receiving a customer order or shipping the goods - Intentional overshipment of goods	Ineffective board of directors, audit committee, or internal audit function; “tone at the top” not conducive to ethical conduct; undue pressure to meet sales targets
	Errors: - Recording sales based on the receipt of orders from customers rather than the shipment of goods - Inaccurate billing and recording of sales - Recording cash that represents a liability (e.g., receipt of a customer’s deposit) as revenue	- Ineffective billing process in which billing is not tied to shipping information - Ineffective controls for testing invoices, or ineffective input validation checks and computer reconciliations to ensure the accuracy of databases - Inadequate accounting manual; incompetent accounting personnel
Early (late) recognition of revenue—“cutoff problems”	Fraud: Holding the sales journal open to record next year’s sales as having occurred in the current year	Ineffective board of directors, audit committee, or internal audit function; “tone at the top” not conducive to ethical conduct; undue pressure to meet sales targets
	Error: Recording sales in the wrong period based on incorrect shipping information	Ineffective cutoff procedures in the shipping department
Recording revenue when significant uncertainties exist	Fraud: Overestimating revenue by underestimating the effects of customers’ rights to return goods	Ineffective board of directors, audit committee, or internal audit function; “tone at the top” not conducive to ethical conduct; undue pressure to meet sales targets
	Error: Recording sales when the customer’s payment is contingent upon the customer receiving financing or selling the goods to another party (e.g., consignment sales)	Aggressive attitude of management toward financial reporting; incompetent chief accounting officer
Recording revenue when significant services (performance obligations) still must be performed by seller	Fraud: Recording franchise revenue when the franchises are sold even though an obligation to perform significant services still exists	Ineffective board of directors, audit committee, or internal audit function; “tone at the top” not conducive to ethical conduct; undue pressure to meet sales targets
	Error: Amount of revenue earned on franchises is miscalculated	Aggressive attitude of management toward financial reporting; incompetent accounting personnel
Overestimation of the amount of revenue earned	Fraud: - Overstating the extent of performance on several contracts by a computer software company - Overestimating the extent of performance on projects by a construction company	- Ineffective board of directors, audit committee, or internal audit function; “tone at the top” not conducive to ethical conduct; incompetent individuals involved in accounting processes - Aggressive attitude of management toward financial reporting; incompetent personnel involved in the estimation/accounting process, or insufficient review procedures
	Error: Overestimating revenue earned due to unintentional misapplication of revenue recognition policies associated with a complex sales contract	Unclear revenue recognition, incompetent personnel involved in the estimation/accounting process, or insufficient review processes

The auditors also should investigate the controls for sales to related parties. Effective control over intercompany or interbranch transfers of merchandise often requires the same kind of formal procedures for billing, shipping, and collection functions as for sales to outsiders; hence, these movements of merchandise are often invoiced and recorded as sales. When the operations of several organizational units are combined or consolidated into one income statement, however, it is apparent that any transactions not representing sales to outsiders should be eliminated from consolidated sales. In the audit of a client that operates subsidiaries or branches, the auditors should investigate the procedures for recording movements of merchandise among the various units of the company and should review the eliminating entries made during the preparation of the consolidated financial statements.

b. Trace details of shipping documents to related sales invoices.

The preceding step in the audit plan called for an examination of selected sales transactions and a comparison of the invoices with sales records and shipping documents. That procedure would not, however, disclose orders that had been shipped but not billed. To obtain assurance that all shipments have been billed, the auditors may select a sample of shipping documents issued during the year and compare these to sales invoices. In designing and performing this test, particular emphasis should be placed upon accounting for all shipping documents by serial number.

When auditing a firm that has an IT system, electronic shipping documents provide the details for invoicing that is performed by the IT system. In these situations, it is unlikely that shipments would not be invoiced if the shipments are accurately and completely input by the shipping department. The auditors will focus their tests of controls on the techniques to ensure accuracy of recording shipments, such as the use of scanning devices to register items shipped.

c. Review the use and authorization of credit memoranda.

All allowances to customers for returned or defective merchandise should be supported by serially numbered credit memoranda signed by an officer or responsible employee having no duties relating to handling cash or to the maintenance of customers' ledgers. Good internal control over credits for returned merchandise usually includes a requirement that the returned goods be received and examined before credit is granted. The memoranda should then bear the date and serial number of the receiving report on the return shipment.

In addition to establishing that credit memoranda were properly authorized, the auditors should perform tests of these documents similar to those suggested for sales invoices. Prices, extensions, and footings should be verified, and postings traced from the sales return journal or other accounting record to the customers' accounts in the subsidiary receivable ledgers.

d. Test controls for over-the-counter sales by reconciling cash register records or sales tickets with sales journal.

In the audit of clients that make a substantial amount of over-the-counter sales, the auditors may compare selected daily totals in the sales journal with cash register readings or tapes. The serial numbers of all sales tickets used during the selected periods should be accounted for and the individual tickets examined for accuracy of calculations and traced to the sales summary or journal. If the client uses electronic point-of-sale terminals with effective controls, the auditors may be able to obtain this evidence by testing the computer application controls.

e. Test management review controls.

If **management review controls** are suitably designed, the auditors may decide to test their operating effectiveness. The auditors will evaluate management review controls by considering the relevance and precision of the controls. Relevance is based on whether the controls address appropriate financial statement assertions; the precision of the controls depends on the level of aggregation of the data, the consistency of performance,

the predictability of management expectations, and the criteria used to determine when items are investigated. The auditors can test the operating effectiveness of the controls by inspecting documentation of performance of the controls, including the manner in which unusual items or relationships were identified, investigated, and resolved.

f. Test controls over estimates related to revenue and receivables.

When a client uses accounting principles that require estimates of significant amounts of revenue, the auditors may decide to evaluate and test the controls over the estimates. The auditors will evaluate the competence of personnel involved in developing the estimates. They will also test the controls over the accumulation of relevant, reliable data to base the estimates. Finally, the auditors will examine evidence of management review and approval of the assumptions and related estimates.

The auditors may also decide to evaluate and test the controls over the development of the estimates of uncollectible amounts. The auditors will evaluate the competence of the personnel involved in developing the estimates. Generally, input from accounting, sales, and credit department personnel should be involved. The auditors may evaluate and test the completeness and reliability of the data used by the client to develop the estimates.

Focus on the Airline Industry

Electronic ticketing, basic to the airline industry, allows a passenger to electronically book a flight using any of a variety of devices and to be assigned a reservation number rather than being issued a physical ticket. Because no ticket is created for the flight, auditors are limited in the extent to which they can examine “paper” support for transactions. Accordingly, audit procedures should be developed relating to the associated revenues and receivables. Auditors often choose to include tests of the computer controls in such situations.

2. If Necessary, Revise the Risks of Material Misstatement Based on the Results of Tests of Controls.

When the auditors have completed the procedures described in the preceding sections, they should reassess the extent of the risk of material misstatement for each financial statement assertion regarding receivables and sales transactions. These assessments will determine whether the auditors should modify their planned substantive procedures for the financial statement assertions about receivables and sales. Figure 11.5 summarizes the relationships among these assertions, the controls, and typical tests of controls. This figure illustrates which controls affect the auditors’ assessment of the risks of material misstatement for the various assertions.

E. Perform Further Audit Procedures—Substantive Procedures for Receivables and Revenue.

1. Obtain an Aged Trial Balance of Trade Accounts Receivable and Analyses of Other Accounts Receivable and Reconcile to Ledgers.

An **aged trial balance** of trade accounts receivable at the audit date is commonly prepared by employees of the client for the auditors, often in the form of a computer print-out. The client-prepared schedule illustrated in Figure 11.6 has a multipurpose format designed to display the aging of customers’ accounts, the estimate of probable credit losses, and the confirmation control information. The summary of so many phases of the examination of receivables in a single working paper is practicable only for small concerns with a limited number of customers. If the client has any accounts receivable other than trade accounts, the auditors also should obtain similar analyses of those accounts.

When trial balances or analyses of accounts receivable are furnished to the auditors by the client’s employees, some independent verification of the listing is essential. Determination of the proper extent of testing should be made in relation to the adequacy of the controls over receivables. The auditors should electronically or manually test footings, cross-footings, and agings. In testing agings, it is important to test some accounts

Primary Audit
Objectives:

Valuation



FIGURE 11.5 Relating Controls to Assertions

Control	Typical Tests of the Control	Existence & Occurrence	Completeness	Cutoff	Rights & Obligations	Valuation & Accuracy	Presentation & Disclosure
Segregate duties over sales and collections of receivables.	Observe and make inquiries about the performance of various functions.	X	X		X	X	
Match sales invoices with shipping documents, purchase orders, and sales orders.	Select a sample of sales invoices and compare details to shipping documents, purchase orders, and sales orders.	X		X	X	X	
Review of the clerical accuracy of sales invoices by a second person.	Select a sample of sales invoices and examine them for evidence of second-person review.						X
Obtain credit approval of sales prior to shipment.	Make inquiries about credit policies; select a sample of sales transactions and examine evidence of credit approval.	X					X
Mail monthly statements to customers and follow up on errors reported.	Observe and make inquiries about the mailing of statements and review evidence of follow-up.	X	X		X	X	
Reconcile bank (financial institution) accounts monthly.	Review a sample of bank reconciliations performed during the year.	X			X	X	
Use control listing to control cash collections.	Observe, make inquiries about the process, and reconcile selected listings to the bank and accounting records.	X	X		X	X	
Use budgets and analyze variances from actual amounts.	Examine budgets and evidence of follow-up on variances.	X	X		X	X	
Use prenumbered shipping and billing documents, and account for the sequence.	Observe and make inquiries about the use of prenumbered documents and inspect evidence of accounting for the sequence.		X	X			
Use credit memoranda for authorization of adjustments to sales and receivables.	Select a sample of credits to customers' accounts and inspect credit memoranda and other supporting documents.		X			X	
Use a chart of accounts and an independent review of account classifications.	Inspect the chart of accounts and evidence of the review of account classifications.						X

classified as current, as well as those shown as past due. These selected accounts should be traced to the subsidiary ledgers. The totals of schedules prepared by client personnel also should be compared with related controlling accounts. In addition, the balances of the subsidiary ledger records should be verified by footing the debit and credit columns on a test basis. Generalized computer audit programs may be used to perform these tests when the client's accounts receivable are processed by an IT system.

2. Obtain Analyses of Notes Receivable and Related Interest and Reconcile to the General Ledger.

An analysis of notes receivable supporting the general ledger control account may be prepared for the auditors by the client's staff. The information to be included in the analysis normally will include the name of the maker, date, maturity, amount, and interest rate. In addition to verifying the accuracy of the analysis prepared by the client, the auditors should trace selected items to the accounting records and to the notes themselves.

Primary Audit Objectives:	
Valuation	☒
Accuracy	☒

Equity Funding Fraud



were thus signed and returned to the auditors by the recipients. Note that matching confirmation request addresses through use of data analytical audit software such as ACL or IDEA would quickly detect such a fraud.

[illegible]

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Rights	☒

The inspection of notes receivable on hand should be performed concurrently with the count of cash and securities to prevent the concealment of a shortage by substitution of cash for misappropriated negotiable instruments, or vice versa. Any securities held by the client as collateral for notes receivable should be inspected and listed at the same time. The auditors should maintain complete control over all negotiable instruments until the count and inspection are completed.

Notes receivable owned by the client may be held by others at the time of the examination. Confirmation in writing from the *holder* of the note is considered an acceptable alternative to inspection; it does not, however, eliminate the need for securing confirmation from the *maker* of the note. The confirmation letter sent to a bank, collection agency, secured creditor, or other holder should contain a request for verification of the name of the maker, the balance of the note, the interest rate, and the due date.

Printed note forms are readily available at any bank and may be easily prepared using commercially available software; an unscrupulous officer or employee of the client company desiring to create a fictitious note could do so by obtaining a bank note form and filling in the amount, date, maturity, and signature. The relative ease of creating a forged or fictitious note suggests that physical inspection by the auditors represents a less significant and conclusive audit procedure for verification of notes receivable than for cash or securities.

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Rights	☒
Valuation	☒
Accuracy	☒

4. Confirm Receivables with Debtors.

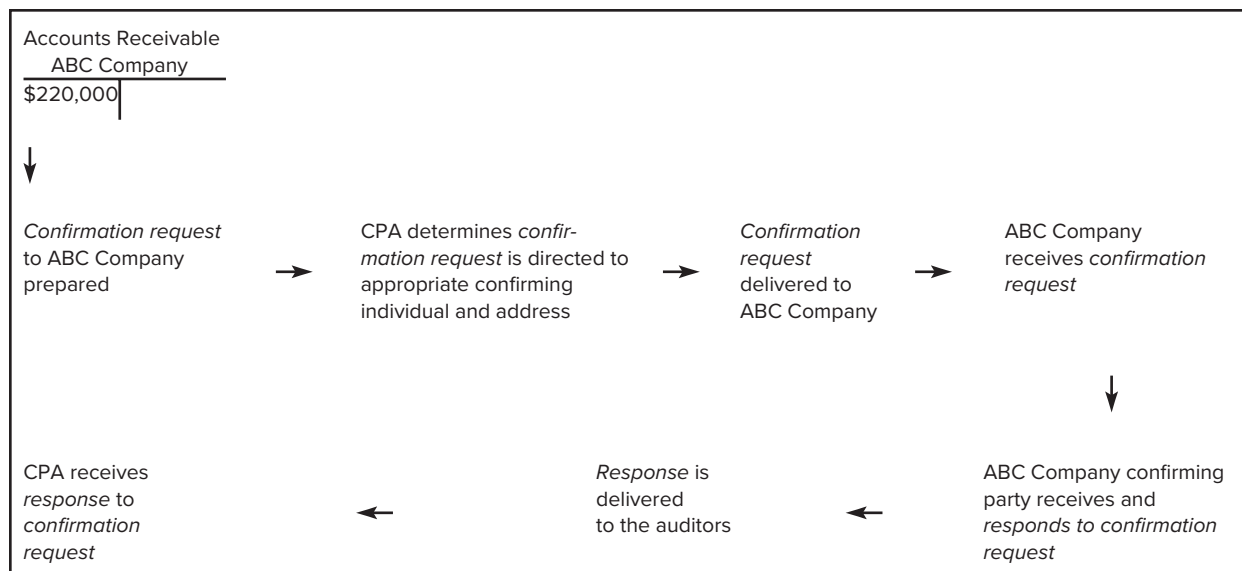
An **external confirmation** is audit evidence obtained by the auditors as a direct written response (reply) to the auditors' **confirmation request** sent to a third party (the **confirming party**). The external confirmation may be in paper form, electronic form, or other medium (e.g., the auditors' direct access to information held by a third party). Direct communication with debtors often is the most essential and conclusive step in the verification of accounts and notes receivable. By obtaining written acknowledgment of the debt by the debtor, the auditors obtain audit evidence that helps (a) establish the existence and gross valuation of the asset and (b) provides some assurance that no lapping or other manipulation affecting receivables is being carried on at the balance sheet date. However, the confirmation of a receivable provides only limited evidence about the completeness and valuation assertions because only recorded amounts are confirmed, and debtors may acknowledge debts even though they are not able to pay them.

A better understanding of the emphasis placed on confirmation of receivables can be gained by a brief review of auditing history. Audit objectives and procedures were drastically revised in the late 1940s. Before that time, the usual audit did not include procedures to assure that the receivables were genuine claims against existing companies or that inventories actually existed and had been accurately counted. Requiring the auditors to confirm receivables (or to observe the taking of physical inventory) was considered too expensive and not particularly important. Auditors generally relied in that early era upon a written statement by management concerning the validity of receivables and the existence of inventories. This approach was drastically revised after some spectacular fraud cases involving millions of dollars in fictitious receivables and inventories showed the need for stronger audit evidence.

The professional standards (AICPA AU-330; PCAOB AS 2310) indicate that the auditors should confirm accounts receivable, unless (a) accounts receivable are immaterial, (b) the use of confirmations would be ineffective, or (c) the auditors' assessment of the risk of material misstatement is low and the auditors plan to obtain sufficient appropriate audit evidence by performing other substantive procedures. This requirement differs from the international auditing standards that accept confirmation as an audit procedure but do not state that auditors should use confirmation requests in any particular situations.

Figure 11.7 shows the steps involved in the accounts receivable confirmation process, whether it be by hard copy or electronic. Sending confirmation requests in paper form is still a common approach used by auditors. As discussed in Chapter 5, such externally generated evidence potentially offers very relevant and reliable evidence. However, in both hard-copy and electronic environments, various risks are involved, including

- The information may be delivered to an inappropriate address and signed by a non-authentic source. For example, if CPAs are provided an incorrect address for ABC Company, the individual that controls that address may fraudulently respond to the confirmation.

FIGURE 11.7 Accounts Receivable Confirmation Process

- Improper intervention into the delivery of a properly addressed confirmation request. For example, CPA placement of a confirmation in an unsecure mail bag (or electronic delivery through an insecure channel) may make it possible for a nonauthentic source to intervene and respond.
- The information may be delivered properly to a debtor company, but an inappropriate individual may respond. For example, an employee of ABC Company in purchasing, who has no knowledge of the balance due but an interest in maintaining a “no problem” relationship with the supplier, may simply sign the confirmation with no exception noted.

Throughout the confirmation process, the auditors should be alert for any indications that confirmations have been intercepted or altered. To control those risks, the auditors should determine that the confirmations are directed toward an appropriate confirming party at a proper address. Ordinarily, one would expect an individual within the customer’s accounts payable function to be such a respondent. Concerning the address used, a sample of addresses may be verified through use of the Internet as well as through information available from the client (e.g., customer orders). Note, however, that simply using address information provided by the client alone may not disclose a fraud in which client personnel have created false receivables and related documentation. When using paper confirmations, the auditors should thoroughly investigate any suspicious circumstances, such as an excessive number of *individual* debtors with addresses that are post office boxes; the boxes may have been rented under fictitious debtors’ names by employees of the client company who are engaged in accounts receivable fraud. Electronic confirmations sent via e-mail may offer similar challenges to the auditors in assuring that they have proper addresses. The auditors may wish to telephone prospective respondents to determine that correct e-mail addresses are being used.

When using the paper form, the auditors should thoroughly control the entire process. All requests for confirmation of notes and accounts receivable should be mailed in envelopes bearing the CPA firm’s return address. A stamped or business reply envelope addressed to the office of the auditors also should be enclosed with the request. Confirmation requests should be mailed personally by the auditors at a post office or in a government mailbox. These procedures are designed to prevent the client’s employees from having any opportunity to alter or intercept confirmation requests or the customers’ responses. The entire process of confirming receivables is subject to manipulation if the confirmation requests or responses from customers pass through the hands of client personnel. Requests returned as undeliverable by the post office may be of prime significance to the auditors and hence should be returned directly to their office.

Various electronic approaches are used for confirming balances. For example, the auditors may transmit the confirmation request via e-mail using a scanned copy of the document that has been signed by a client. When e-mail is used, the auditors should maintain control over the electronic confirmation requests and responses. As indicated earlier, the auditors ordinarily will verify e-mail addresses supplied by management. When electronic responses are received, auditors will validate the source of the electronic information. For example, the use of *encryption* and a *digital signature* may be used to validate the source.

As discussed in Chapter 10, the customer (confirming party) or a trusted third-party provider may also provide the auditors (with the client's authorization) access to a secure website that contains the requested information. Because the website location and access information are obtained directly from the confirming party or a trusted third-party service provider, the auditors can consider the information confirmed by the third party. Some CPA firms also use software **bots** to automate the entire confirmation process, including requesting the information, following up on nonrespondents, and summarizing the results including sampling results, if applicable.

To improve the rate of responses to confirmation requests, the auditors should carefully design the form to make sure that the person receiving the confirmation is likely to have easy access to the information requested. For example, customers that use a voucher system for cash disbursements may be better able to confirm individual unpaid transactions, rather than total receivable balances. The auditors also should try to include on the form the details of the transactions, such as customers' purchase order numbers.

In some cases, the confirmation process may involve obtaining oral responses, generally through a telephone call made by an auditor to the responding individual. Oral responses do not meet the definition of an external confirmation, which is defined as including a written response. When the auditors consider a written response to be necessary, they should request the individual making the oral response to also respond in writing directly to the auditors. If the written response is not received, alternative audit procedures will not provide sufficient and appropriate audit evidence; the auditors should determine the implications for the audit and the auditors' report (i.e., a scope limitation is involved that, if considered significant enough, may result in either a qualified opinion or a disclaimer of opinion as discussed in Chapter 17). If the auditors conclude that a written response is not required, they should properly document the oral response in the working papers (e.g., including details on the identity of the responding individual and the date and time of the conversation). When relying on oral responses, the auditors may perform additional precautionary procedures such as initiating the call to the respondent using a telephone number independently obtained.

Positive and Negative Confirmation Requests

There are two methods of confirming receivables by direct communication with the debtor. In each type of communication, the *client* makes the formal request for confirmation, although the auditors control the entire confirmation process.

The use of **positive confirmation requests**, as illustrated by Figure 11.8, consists of a request addressed to the debtor asking for a response. Most positive forms ask the debtor to confirm directly to the auditors the accuracy of the dollar amount shown on the confirmation request. In this request, the entire balance due as of month end is being confirmed, as contrasted to individual unpaid transactions.

Other positive forms, referred to as *blank forms*, do not state the amount on the request, but ask the debtor company to fill in the balance due (either for the account as of month-end or for one or more individual unpaid transactions). Blank forms are generally not used for accounts receivable because the additional time involved in completing the form generally results in a lower response rate.

The use of **negative confirmation requests** consists of a communication addressed to the debtor company asking it to advise the auditors *only* if the balance shown is incorrect. A negative confirmation request may be in the form of a letter or it may be made

FIGURE 11.8
Positive Form of
Accounts Receivable
Confirmation Request
(with Customer
Response)

SMITH & CO. _____ 1416 Eighteenth Street · Los Angeles · California · 90035	
Martin, Inc. 6700 Holmes Street Kansas City, Missouri 64735 Dear Sirs: Please confirm directly to our auditors Adams, Barnes & Co. Certified Public Accountants 1800 Avenue of the Stars Los Angeles, California 90067 the correctness of the balance of your account payable to us as shown below and on the enclosed statement at December 31, 20X1. If the amount is not in agreement with your records at that date, please provide any information which will aid our auditors in reconciling the difference. Your prompt return of this form in the enclosed stamped envelope is essential to the completion of the audit of our financial statements and will be appreciated. Smith & Co. By <u><i>M.J. Crowley</i></u> (Controller) THIS IS NOT A REQUEST FOR PAYMENT, BUT MERELY FOR CONFIRMATION OF YOUR ACCOUNT. ----- The statement of our account showing a balance of \$24,689.00 due Smith & Co. at December 31, 20X1, is correct except as noted below. Date: <u>January 16, 20X2</u> Exceptions: <u>None</u> _____ _____ Martin, Inc. By <u>Howard Martin</u>	December 31, 20X1

merely by applying a rubber stamp to the customer's regular monthly statement, or by attaching a gummed label bearing the words shown in Figure 11.9.

When the negative form of confirmation request is used, the lack of a response from a given customer is interpreted as satisfactory evidence, when in fact the customer may simply have ignored the confirmation request or, in an electronic environment, not seen it because it was not received or was caught in a spam filter and not detected. Because the auditors need not follow up on nonreplies, the expense of using negative confirmation requests is less than for the positive form; thus, more customers can be contacted for the same or less cost.

The positive form provides more assurance than the negative form because the auditors are alerted to the need for further investigation if a response is not received. However, when positive confirmations ask recipients to confirm the accuracy of information provided on the request, there is a risk that the recipient may simply sign and return it

FIGURE 11.9
Negative Form of
Accounts Receivable
Confirmation Request

Please examine this statement carefully. If it does not agree with your records, please report any differences to our auditors.

Adams, Barnes & Co.
 Certified Public Accountants
 1800 Avenue of the Stars
 Los Angeles, California 90067

A business reply envelope requiring no postage is enclosed for your convenience.

THIS IS NOT A REQUEST FOR PAYMENT

without verifying the information. Blank forms control this risk by requiring the recipient to provide the information. But blank confirmations generally result in lower response rates and, therefore, require more follow-up procedures.

Although positive confirmation requests may be used in any circumstance, negative requests, in combination with other substantive audit procedures, may help provide sufficient appropriate audit evidence in circumstances such as when (a) the assessed level of the risk of material misstatement is low and sufficient appropriate audit evidence has been obtained on operating effectiveness of controls; (b) a large number of small, homogeneous balances are involved; (c) a low exception rate is expected; and (d) the auditors are not aware of circumstances that would cause recipients of the request to disregard them. In many situations, a combination of positive and negative confirmation requests is used, with the positive form used for large balances and the negative form for small balances.

Size of Sample

In the audit of most companies, the confirmation process for accounts receivable is limited to a sample. The sample should always be large enough to warrant the drawing of valid inferences about the entire population of receivables. Generally, auditors are able to stratify the population in a manner that allows confirmation of a majority of the dollar amount of receivables.

As discussed in Chapter 9, the size of the sample will vary with the levels of sampling risk accepted (the risk of incorrect rejection and acceptance), the tolerable misstatement, and certain characteristics of the population. The results of confirmation tests in prior years may serve as another factor in setting sample size; significant exceptions in prior years' confirmation results signal the need for extensive confirmation of the current year's receivables. Finally, the choice between the positive and negative forms of confirmation requests influences the size of the sample. The number of confirmations mailed is usually increased when the negative form is used.

In selecting the individual accounts to be confirmed, it is customary to include all customers with balances above a selected dollar amount and to select a sample of accounts from the remaining receivables. Generalized audit software is useful in stratifying computer-processed accounts receivable to facilitate the selection of a representative sample.

Management's Refusal to Allow the Auditors to Confirm Particular Accounts

If management refuses to allow the auditors to perform external confirmation procedures on particular accounts, the auditors should inquire and evaluate management's reasons, evaluate the implications of this refusal to the assessment of the risks of misstatement, and perform alternative audit procedures designed to obtain relevant and reliable audit evidence about the accounts. In the rare situations in which the auditors determine management's request to be valid and they are able to obtain sufficient evidence, there will be no effect on the audit opinion. If the auditors do not consider management's reasons to be valid, or if the auditors are unable to obtain relevant and reliable audit evidence from alternative audit procedures, the auditors should communicate with those charged with

governance about the matter. The auditors also should determine the implications for the auditors' opinion since this represents a scope limitation that may result in either a qualified opinion or a disclaimer of opinion (Chapter 17 discusses scope limitations in detail).

Discrepancies in Customers' Responses

The auditors should resolve differences reported by customers. The majority of such reported discrepancies arise because of normal lags in the recording of cash receipts or sales transactions or because of a misunderstanding on the part of the customer company as to the date of the balance it is asked to confirm. Some responses may state that the balance listed is incorrect because it does not reflect recent cash payments; in such instances, the auditors normally trace the reported payments to the cash records.

Restrictions in Customers' Responses

A customer's response to a receivable (or other account) confirmation request may contain restrictive language concerning its use. Depending upon their nature, such restrictions may or may not invalidate the reliability of the response as audit evidence. AU-C 505 suggests that "boilerplate" disclaimer of liability such as the following may not affect the reliability of the information confirmed: "Information is furnished as a matter of courtesy without a duty to do so and without responsibility, liability, or warranty, express or implied."

Alternatively, certain restrictions may cast doubt about the completeness or accuracy of the information in the response, such as

- "Information is not guaranteed to be accurate nor current and may be a matter of opinion."
- "The recipient may not rely upon the information in the confirmation."

Restrictive language such as these may require the gathering of further audit evidence to resolve the doubts about the accuracy of the account. Examples of such procedures are presented in the following section.

Alternative Audit Procedures for Nonrespondents

The percentage of responses to positive confirmation requests that can be expected will vary greatly according to the type of debtor. When using positive confirmation requests, the auditors should generally follow up with a second and sometimes a third request to produce responses. When responses are still not received, the auditors should apply alternative procedures to the accounts, unless (a) the amount of the nonresponses is not significant when projected as a 100 percent misstatement to the total balance of receivables and (b) there are no unusual characteristics related to the nonresponses. The best *alternative auditing procedure* ordinarily is examination of subsequent cash receipts in payment of the receivable. However, in order to make certain that the payment is for a receivable that existed at year-end, the auditors also may need to examine shipping documents, customer purchase orders, or sales invoices for the sales transactions making up the receivable. Examination of these sales documents is also the alternative procedure used for receivables that are not paid during the subsequent period.

A summary should be prepared for the working papers outlining the extent and nature of the confirmations sent and the overall results obtained. Such a summary is a highly important part of audit documentation.

The Confirmation Process in Perspective

The auditors face more than one type of risk in relying upon the confirmation process to form an opinion about the fairness of the accounts receivable as a whole. We have already recognized the risk that some accounts with erroneous balances may not be included in the confirmation sample, the risk of inappropriate intervention by client personnel, and the risk that responses may not be received from some customers with erroneous balances. Finally, there is also a risk that customers may routinely return confirmation requests without actually comparing the balance with their records. Such responses would give the auditors a false sense of security. Despite these risks, however, the confirming of accounts receivable provides valuable evidence and represents an important part of the auditors' work.



Illustrative Case

Importance of Follow-Up on Nonrespondents

During the first audit of a small manufacturing company, the auditors sent confirmation requests to all customers whose accounts showed balances in excess of \$1,000. Satisfactory responses were received from all but one account, which had a balance of approximately \$30,000. A second confirmation request sent to this customer produced no response; but before the auditors could investigate further, they were informed by the cashier-accountant that the account had been paid in full. The auditors asked to examine the

customer's check and the accompanying remittance advice, but they were told that the check had been deposited and the remittance advice destroyed. Further questioning concerning transactions with this customer evoked such vague responses that the auditors decided to discuss the account with the officers of the company. At this point, the cashier-accountant confessed that the account in question was a fictitious one created to conceal a shortage and that to satisfy the auditors he had "collected" the account receivable by diverting current collections from other customers whose accounts had already been confirmed.

As indicated previously, the best proof available to the auditors as to the existence of an account receivable ordinarily is its collection before completion of the audit. However, this statement requires qualification, as indicated by the situation described in the above *Illustrative Case*.

Reviewing and Confirming Accounts and Notes Written Off as Uncollectible

If any accounts or notes receivable of significant amounts were written off as uncollectible during the year, the auditors should determine that these write-offs were properly authorized. In the absence of proper authorization procedures, a dishonest employee could conceal permanently a theft of cash merely by a charge to accounts or notes receivable followed by a write-off of that asset.

A systematic review of the notes and accounts written off can conveniently be made by obtaining or preparing an analysis of the allowance for doubtful accounts and notes. Debits to the allowance may be traced to the authorizing documents and to the control record of accounts and notes written off; confirmation requests may be mailed to some of the debtors to determine that the account or note was genuine when it was first in the accounts. Credit entries should be compared with the charges to uncollectible accounts and notes expense. Any write-off that appears unreasonable should be fully investigated. Charge-off of a note or account receivable from an officer, stockholder, or director is unreasonable on its face and warrants the most searching investigation by the auditors. Analytical procedures including the computation of the ratios of the year's write-offs to net credit sales, to uncollectible accounts expense, and to the allowance for doubtful accounts may be useful in bringing to light any abnormal write-offs.

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Rights	☒
Cutoff	☒
Valuation	☒
Accuracy	☒

5. Perform Analytical Procedures for Accounts Receivable, Notes Receivable, and Revenue.

During the risk assessment stage of the audit, professional standards require the auditors to perform analytical procedures with the objective of identifying potential misstatements of revenue. Several ratios and relationships can be computed to indicate the overall reasonableness of the amounts shown for accounts receivable, revenue, and notes receivable. Examples include (a) the gross profit rate (by product line, store, or region), (b) the ratio of sales in the last month or week to total sales for the quarter or year, (c) revenue in relation to productive capacity, (d) units shipped in relation to revenues and production records, (e) accounts receivable turnover, (f) the ratio of accounts receivable to the year's net credit sales, (g) the ratio of accounts written off during the year to the ending balance of accounts receivable, (h) the ratio of returns and allowances to sales, (i) the ratio

of interest revenue to notes receivable, and (j) the ratio of uncollectible account expense to credit sales. These ratios and relationships are compared with corresponding data for the preceding years, and with budgets, performance statistics, or comparable industry averages.

In performing analytical procedures related to revenue and receivables, the auditors also will review ledgers and journals for unusual entries or amounts that may be indicative of errors, fraud, or other material issues. While this review may be performed manually, it may be more efficiently and thoroughly performed with the use of data analytics. Data analytics software may examine 100 percent of the transactions or entries in journals and ledgers using the criteria specified by the auditors. As examples, the auditors may

1. Identify possible fictitious revenue by searching for unusual or large entries in revenue accounts.
2. Identify possible fictitious revenue by searching for entries into revenue accounts from unusual sources.
3. Identify possible revenue cutoff errors by examining unusual revenue transactions around year-end.
4. Identify related party transactions in the sales journal by selecting unusual transactions throughout the entire year.
5. Identify possible duplicate billings by reviewing the sales journal for sales of identical amounts to the same customers over a short period of time.
6. Identify possible unauthorized sales discounts by comparing discounts to individual customers in total and as a percentage of total sales.
7. Identify possible uncollectible amounts by identifying credit sales that exceed the amounts of customers' credit authorization amounts.
8. Identify misstatements of accounts receivable by identifying large credits to accounts receivable from unusual sources.

Focus on the Casino Industry

Casinos have few documents to support their revenue transactions. This makes it difficult for auditors to apply tests of details to the revenues of these types of organizations. An AICPA *Audit Risk Alert* on the casino industry emphasizes the use of analytical procedures and data analytics to audit revenues. In developing expectations about the amounts of revenues, the auditors should consider using data analytical approaches incorporating factors such as

- Demographic data of casino clientele.
- Betting limits established by regulatory agencies.
- Effects of adverse weather conditions or special events, such as conventions, on casino attendance.
- Seasonality of casino operations.
- General economic conditions.
- Effects of intense competition.
- Impact of promotional programs.
- Probable win ratios.

Auditors are warned that while, in the long term, fluctuations may be likely to conform to expected patterns, the element of chance—a fundamental characteristic of casino operations—makes short-term fluctuations common.

Primary Audit Objectives:

Existence	☒
Occurrence	☒
Rights	☒
Cutoff	☒
Valuation	☒
Accuracy	☒

6. Review Significant Year-End Sales Contracts for Unusual Terms.

To boost the level of sales for a period, management may be inclined to modify the terms of sales contracts near year-end. These modifications may affect the collectibility of the related accounts receivable, the customers' return rights, and even whether the sales meet the criteria to be recognized in the current period. Therefore, the auditors should

carefully review any significant year-end sales contracts for unusual pricing, billing, delivery, return, exchange, or acceptance clauses.

Primary Audit Objectives:	
Cutoff	☒

7. Review the Year-End Cutoff of Sales Transactions.

One of the more common methods of falsifying accounting records is to inflate the sales for the year by holding open the sales journal beyond the balance sheet date. Shipments made in the first part of January may be covered by sales invoices bearing a December date and included in December sales. The purpose of such misleading entries is to present a more favorable financial picture than actually exists, or to meet analysts' sales expectations. Because sales are frequently used as the base for computation of bonuses and commissions, an additional incentive for padding the sales account is often present.

The section on analytical procedures described data analytic procedures directed at detecting sales transactions recorded in the wrong period. A related abuse affecting accounts receivable is the practice of holding the cash journals open beyond the balance sheet date; auditing procedures designed to detect this practice were described in connection with the audit of cash transactions in Chapter 10.

Misstatements due to inaccurate cutoff of sales records also may be detected by comparing the sales recorded for several days before and after the balance sheet date with the duplicate sales invoices and shipping documents. The effectiveness of this step is largely dependent upon the degree of segregation of duties between the shipping, receiving, and billing functions. If warehousing, shipping, billing, and receiving are independently controlled, it is most unlikely that records in all these departments will be manipulated to disguise shipments of one period as sales of the preceding period. On the other hand, one individual with control over both shipping records and billing documents could manipulate both sets of records to overstate the year's sales.

Fictitious sales are occasionally recorded at year-end as a means of overstating financial results. Therefore, auditors should be aware of and investigate

- Unusually large increases in year-end sales to a single customer or a few. This might be indicative of **bill and hold transactions**, in which sales are billed, but goods are not shipped. Such transactions may not meet the requirements for revenue recognition.
- Large increases in revenue and receivables along with increases in gross profit margins that are inconsistent with the client's experience or industry averages.
- Inappropriate changes in accounting principles that result in an increase in recorded revenue.
- Substantial sales returns following the balance sheet date that might indicate merchandise shipped to customers without a customer order for those goods or **channel stuffing**, in which sales are boosted by inducing customers to buy substantially more inventory than they can promptly resell.
- Substantial revisions in the amounts to be received under sales contracts possibly indicating the application of inappropriate accounting methods or misestimates of the amount of revenue to be realized.

As discussed in Chapter 10, the term **window dressing** refers to actions taken around the balance sheet date to improve the financial picture presented in the financial statements. A number of window dressing practices represent proper and appropriate business practices, such as a special year-end promotion to boost sales and making diligent efforts to ship out all orders. However, window dressing practices such as those listed with the preceding paragraph result in fraudulent misstatements of the financial statements. To guard against such manipulations, the auditors should review carefully all substantial sales returns following the balance sheet date that may apply to receivables originating in the year under audit. Consideration should be given to reflecting these returns in the current year's business by means of adjusting entries. Confirmation of accounts receivable, if performed at the balance sheet date, also should serve to bring any large unauthorized shipments to the attention of the auditors.



Illustrative Case

What Do You Do with Stale Doughnuts?

Krispy Kreme Doughnuts Inc.'s former company and franchise employees stated that the company was double-shipping wholesale orders to some grocers at the end of various quarterly reporting periods in order to temporarily boost sales and earnings, even though executives

knew many of the doughnuts would be returned for credit later. It was reported that it was commonplace for management to inappropriately channel stuff in order to meet analysts' expectations. This was inappropriate because Krispie Kreme's management did not take into consideration the additional amounts of sales returns involved.

Primary Audit Objectives:

Existence	☒
Occurrence	☒
Rights	☒
Completeness	☒

8. Test the Valuation of Notes Receivable, Computation of Interest Income, Interest Receivable, and Amortization of Discount or Premium.

Unless a company elects the fair value option, notes receivable are valued at their outstanding face value plus or minus any unamortized premium or discount. When a company has not adopted the fair value option, the auditors may effectively audit valuation, interest income, interest receivable, and the amortization by performing an independent computation of the interest earned during the year on notes receivable. The working paper used to analyze notes receivable should show the interest rate and date of issuance of each note. The interest section of this working paper consists of four columns, which show for each note receivable owned during the year the following information:

- Accrued interest receivable at the beginning of the year (taken from the preceding year's audit working papers).
- Interest earned during the year (computed from the terms of the notes).
- Interest collected during the year (traced to cash receipts records).
- Accrued interest receivable at the end of the year (computed by the auditors).

These four columns compose a self-balancing set. The beginning balance of accrued interest receivable (first column) plus the interest earned during the year (second column) and minus the interest collected (third column) should equal the accrued interest receivable at the end of the year (fourth column). The totals of the four columns should be cross-footed to ensure that they are in balance; in addition, the individual column totals should be traced to the balances in the general ledger.

If the interest earned for the year as computed by the auditors does not agree with interest earned as shown in the accounting records, the next step is an analysis of the ledger account. Any unaccounted-for credits in the Interest Earned account deserve particular attention because these credits may represent interest received on notes that have never been recorded.

For financial institutions or other clients having numerous notes receivable, the auditors may verify interest computations on only a sample of the notes. In addition, they should test the reasonableness of total interest earned for the year by applying a weighted average rate of interest to the average balance of the Notes Receivable ledger account during the year.

The fair value option for valuation of notes receivable (as presented in Chapter 5) is available. When the fair value option has been elected, the auditors should evaluate the propriety of the valuation techniques and inputs (assumptions) used.

9. Evaluate the Propriety of the Client's Accounting Methods for Receivables and Revenue.

As indicated earlier in this chapter, many instances of misstatements in financial statements have involved the inappropriate recognition of revenue and related receivables—often through the premature recording of revenues or the recording of fictitious revenues.

Primary Audit Objectives:

Valuation	☒
Accuracy	☒

Previous steps in this audit plan have addressed this risk through consideration of a proper year-end cutoff of sales transactions (step 5); performance of analytical procedures for accounts receivable, notes receivable, and revenue (step 6); and the review of significant year-end sales contracts for unusual terms (step 7). In step 9, we directly address the propriety of the accounting methods relating to receivables and revenue.

FASB Revenue Recognition Standard

Conceptually, an entity should recognize revenue in amounts that reflect the consideration the entity expects to receive for sales of goods or services as performance obligations are satisfied. The FASB recently issued a new revenue recognition standard for accounting for revenue from contracts with customers. FASB ASC 606, which superseded much of previous industry-specific guidance, establishes a five-step process for recognizing revenue from contracts with customers:

Step 1: Identify the Contract. A contract contains a promise or promises to transfer goods or services to a customer. It can be written, oral, or implied by customary business practice.

Step 2: Identify the Performance Obligations. ASC 606 distinguishes between performance obligations and other obligations. The distinction is important since the standard makes clear that revenue should only be recognized based on completion of a *performance* obligation, one that transfers control of goods or services to a customer. *Other* obligations such as setting up a customer's account do not result in the recognition of revenue. Identifying performance obligations may be relatively straightforward, such as when a department store contracts to deliver a large-screen television to a customer. Alternatively, it can be more complex, such as a contract to provide a new computer system with a three-year software license, a right to upgrades, and technical support. Management evaluates whether to account for performance obligations separately or as a group. In some cases, two or more separate contracts negotiated with the same customer should be combined and accounted for as a single contract.

Step 3: Determine the Transaction Price. The transaction price is the amount of consideration management expects to be entitled to receive from a customer in exchange for providing the goods or services. A number of factors should be considered to determine the transaction price, including whether there is variable consideration, a significant financing component, noncash consideration, or amounts payable to the customer. If certain amounts under the contract are variable, the contract price should be estimated, and only include the recognition of revenue for which it is probable there will be no significant reversal. Examples of terms that create variable contract amounts include discounts, rebates, and guaranteed service performance level agreements.

Step 4: Allocate the Transaction Price to the Performance Obligations. If the contract contains multiple performance obligations, the transaction price should be allocated to the separate performance obligations based on the relative stand-alone selling prices of the goods or services. Determining the relative stand-alone selling price can be challenging when goods or services are not sold on a stand-alone basis. The revenue recognition standard sets out several methods that can be used to estimate a stand-alone selling price when one is not available, for example, the adjusted market assessment approach and the expected cost plus a margin approach. In principle, this allocation is made based on the relative value of the various performance obligations.

Step 5: Recognize Revenue When the Performance Obligations Are Satisfied. Revenue is recognized when the performance obligations are satisfied. The revenue recognition standard provides guidance to help determine whether a performance obligation is satisfied at a point in time or over time. When a performance obligation is satisfied over time, the related revenue is recognized over that same time period. A modification of the terms of a contract, depending on its nature, is accounted for prospectively or through a cumulative catch-up adjustment.

These criteria apply to sales contracts that are not covered by other financial standards, such as lease contracts. In addition, certain criteria must be met before a contract can be accounted for using the five-step model. Specifically, management must conclude that it is *probable* that the contract amounts will be collected. Under ASC 606, *probable* is defined as likely to occur.⁴

Certain contracts may include elements that are covered by the revenue recognition standard and other elements that are excluded. As an example, a contract for the lease and maintenance of equipment includes a lease element that is covered by lease accounting standards and a maintenance element that is covered by the revenue recognition standard.

Some entities enter into contracts with a large number of customers that have the same or similar terms and conditions. In these situations, management should consider whether the revenue standard could be applied to a portfolio of contracts or performance obligations. As an example, the portfolio approach might be appropriate in estimating product returns when the goods sold are similar. It is unlikely that a portfolio approach would be acceptable when the contracts involve the sale of dissimilar products or when contract terms vary significantly. Determining when the use of a portfolio approach is appropriate requires judgment and a consideration of all of the facts and circumstances.

Incremental costs of obtaining or fulfilling a contract should be capitalized if they are expected to be recovered. As an example, sales commissions and shipping costs generally should be capitalized. If the costs are not expected to be recovered, they should be expensed as incurred.

Auditing Revenue Recognition

In an overall sense, audit procedures for revenue recognition involve obtaining reasonable assurance that management has followed generally the appropriate accounting framework. If the framework is accounting standards generally accepted in the U.S., management should recognize revenue applying the five steps previously described.

Because revenue recognition may involve difficult judgments by management, especially when the sales contract terms are complex, the audit of revenue transactions may involve a high degree of risk. In these situations, the auditors should expect management to have established effective controls, including engaging competent personnel in developing the estimates, and establishing effective **management review controls** to identify errors or fraud should they occur. The auditors should assess effectiveness of these controls in preventing and detecting material misstatements and perform appropriate tests of controls to determine whether the controls are operating effectively.

To effectively audit revenue transactions, auditors need a thorough understanding of the terms of the related contracts and whether management's accounting for the transactions conforms to the related accounting standards. If management employs a portfolio approach to recognition of revenue, the auditors may decide to review a sample of the contracts issued during the period for consistency of terms that affect revenue recognition. Some auditors are using artificial intelligence software to read and classify contracts based on the terms that affect the amount and timing of revenue recognition.

Once the auditors have a thorough understanding of contract terms, they should evaluate significant assumptions made by management regarding application of the revenue recognition standards. As an example, auditors must evaluate the reasonableness of management's assessment of the probability of collection of the amounts under contract. This generally will involve consideration of the history of collection of amounts under similar contracts and evaluation of the creditworthiness of the specific customers. The application of analytical procedures may provide relevant audit evidence.

Auditors should evaluate the determination of the transaction price and the related performance obligations, considering the terms of the contract and customary business practices. For complex contracts, the auditors also should determine whether management

⁴ Academic research studies have estimated likely to occur to be 65 to 70 percent or more. International Financial Reporting Standard No. 15 corresponds to FASB ASC 606. Under IFRS 15, *probable* is defined as more likely than not, or more than a 50 percent probability of collection.

is appropriately accounting for complexities such as multiple performance obligations, variable or noncash consideration, or significant financing components. Problems that the auditors might encounter in auditing revenue recognition include

- a. Estimates of revenue recognized might not give consideration to sales return rights that have been granted to customers.
- b. Management or client personnel may have established, formally or informally, **side agreements** that significantly alter the terms of sale.
- c. Cash receipts from franchise fees may be inappropriately recognized when services have not been rendered to the franchisees.
- d. Bill and hold transactions may be recorded when they do not meet the requirements for revenue recognition.
- e. Notes receivable may not bear reasonable interest rates at the time they are accepted, resulting in a need to discount the notes to present values.
- f. Management of a construction contractor might overestimate the amount of revenue earned.
- g. Management of a software company might sell goods and services under a contract with multiple performance obligations and inappropriately overload revenue recognized on the performance obligations completed initially.

The following illustration focusing on the construction industry makes it clear that auditors should have a thorough understanding of generally accepted accounting principles and the *substance*, as well as the form, of the client's revenue transactions. The auditors should carefully review the entity's controls, and the various documents pertaining to the transactions, to determine that proper accounting principles have been followed. If they believe that there is a risk that the terms of contracts may have been modified, they should consider confirming the terms with the customer.

Focus on the Construction Industry

Construction contractors often use the cost-incurred to estimate the total cost to complete method to recognize income on long-term contracts. Under this method, a contractor computes the extent of progress toward completion of each contract in progress. For example, if a contract is 70 percent complete at year-end and on target cost-wise, the contractor will recognize 70 percent of the contract's revenues, costs, and gross profit. Although the method is well established in the construction industry, auditors should carefully consider whether the contractor's estimate of costs to complete the contracts is reasonable, and whether it is probable that losses may be incurred on the contract. When making this determination, auditors should consider

- The controls over the contractor's estimation process, including the competence of the personnel making the estimates, and supervisory review of calculations of amounts.
- Explanations for apparent disparities between estimates and past performance on contracts.
- Information gained in other areas of the audit.
- Industry and economic conditions, and expected future trends.

When slow economic growth is expected and intense competition exists, there may be an increased risk that a construction contractor may be inclined to compensate for low revenue growth by underestimating the costs to complete projects. Overestimating the extent of performance is another way of underestimating costs.

Primary Audit Objectives:	
Valuation	☒
Accuracy	☒

10. Evaluate Accounting Estimates Related to Revenue and Receivables.

The auditors are responsible for evaluating the reasonableness of accounting estimates related to receivables and the recognition of revenue. Examples of these accounting estimates include sales returns, revenue recognized under very complex agreements, and the allowance for uncollectible accounts. In accordance with AICPA AU-C 540 and PCAOB AS 2501, the auditors audit accounting estimates by reviewing and testing management's

process of developing the estimates, by developing their own estimates, or by reviewing subsequent transactions and other events that provide evidence about the accuracy of the estimates. Most often the auditors use the approach of reviewing and testing management's process. The auditors will consider the competence of the employees involved in developing the estimates, and evaluate whether management has considered all of the factors that could bear on the estimate, including those such as changes in economic conditions, the makeup of customers, or contract terms.

Because fraudulent financial reporting often is accomplished through the intentional misstatement of accounting estimates, the auditors are required to perform a retrospective review of the prior year's significant accounting estimates to determine whether they indicate bias on the part of management. As an example, the auditors of a construction contractor may compare prior-year estimates of cost to completed projects with the actual costs incurred. If these comparisons indicate a bias on the part of management, the auditors will use this information in auditing the current year accounting estimates.

Primary Audit
Objectives:

Valuation



11. Determine the Adequacy of the Client's Allowance for Uncollectible Accounts.

The allowance for uncollectible accounts represents a particularly significant accounting estimate for most organizations. Accordingly, we will provide a detailed explanation of the audit procedures applied to this account. As a starting point, the retrospective analysis of accounting estimates described in the preceding section provides overall information about the quality of management's prior estimates. This information will almost certainly influence the auditors' approach to auditing the allowance account, which may primarily involve evaluating management's process of developing the estimate, reviewing subsequent transactions, or developing the auditors' own estimate.

If the auditors elect to use the overall approach of evaluating management's process, they will consider both the reasonableness of the process and the competence of the personnel involved. If the process is well designed and controlled, the auditors may decide to focus on tests of controls to obtain much or all of the evidence about the reasonableness of the allowance.

Because the best evidence of the *collectibility* of accounts receivable is payment by the debtors subsequent to the balance sheet date, the approach of analyzing subsequent transactions is also an appropriate overall audit approach. In the audit working papers, the auditors should document the subsequent payments inspected; the illustrated trial balance of trade accounts receivable (Figure 11.6) includes a special column for this purpose.

The auditors also may decide to independently develop their own estimate of the amount of uncollectible receivables to compare to management's estimate. The following procedures may be used by the auditors both in developing an estimate and in evaluating the reasonableness of management's estimate:

- a. Compare the details of the aging of accounts receivable to prior years' aging. Examine the past-due accounts receivable listed in the aging schedule that have not been paid subsequent to the balance sheet date, noting such factors as the size and recentness of payments, the settlement of old balances, and whether recent sales are on a cash or a credit basis. The client's customer correspondence file may contain much of this information.
- b. Investigate the credit ratings for delinquent and unusually large accounts. This is particularly efficient when receivables from one or a few customers represent a major portion of the total. Financial statements and credit data should be available in the client's credit files.
- c. Review confirmation exceptions for an indication of amounts in dispute or other clues as to possible uncollectible accounts.
- d. Summarize in a working paper those accounts whose collectibility is doubtful based on the preceding procedures. List customer names, doubtful amounts, and reasons for considering these accounts doubtful.

- e. Review with the credit manager the current status of significant doubtful accounts, determining the collection action taken and the opinion of the credit manager as to ultimate collectibility. Indicate in the working papers the credit manager's opinion as to the collectible portion of each account listed, and use this information to assist in evaluating the collectibility of specific accounts.⁵
- f. Compute relationships, such as the number-of-days' sales in accounts receivable and the relationship of the valuation allowance to (a) accounts receivable and (b) net credit sales. Compare the ratios to comparable ratios for prior years and industry averages and investigate any unexpected results.
- g. As described previously, data analytics may be used to identify past-due receivables, receivables with related parties, receivables with balances in excess of credit limits, and receivables with relatively low subsequent payments.

After completion of procedures such as those listed, the auditors will determine the reasonableness of management's estimate of the allowance for uncollectible accounts.

To appraise the collectibility of notes receivable, the auditors may investigate the credit standing of the makers. Reports from credit-rating agencies and financial statements from the makers of the notes should be available for this purpose in the client's credit department. Evaluation of any collateral supplied by makers of notes is another step in determining the collectibility of notes receivable. The auditors should determine the current market value of securities held as collateral by the client, either by reference to market quotations or by inquiry of brokers.

12. Ascertain Whether Any Receivables Have Been Pledged.

The auditors should inquire directly as to whether any notes or accounts receivable have been pledged or assigned. Evidence of the **pledging of receivables** also may be disclosed through the medium of financial institution confirmation requests, which specifically call for a description of the collateral securing bank loans. Analysis of the interest expense accounts may reflect charges from the pledging of receivables to finance companies.

Accounts receivable that have been pledged should be plainly identified through coding in the accounts receivable records. Accounts labeled in this manner would be identified by the auditors in their initial review of receivables and confirmed by direct correspondence with the bank to which they were pledged. The auditors cannot, however, proceed on the assumption that all pledged receivables have been labeled to that effect, and they should be alert to detect any indications of an unrecorded pledging of accounts receivable.

13. Investigate Any Transactions with or Receivables from Related Parties.

Transactions between the corporation and its officers, directors, stockholders, or affiliates require particular attention from the auditors because these related party transactions are not the result of arm's-length bargaining by parties of opposing interests. Furthermore, such transactions may be prohibited by federal or state law or by the corporation's bylaws. The independent auditors have an obligation to stockholders, creditors, and others who rely upon audited statements to require adequate disclosure of any significant related party transactions.

To identify related party transactions, in addition to making inquiries of management and other employees, the auditors should review (a) proxy and other filings with the SEC or other regulatory agencies, (b) conflict-of-interest statements obtained by the company from its management, (c) transactions with customers or suppliers that have unusual terms, and (d) accounting records for unusual balances or transactions, particularly those occurring near year-end. If related party transactions are identified, the auditors should obtain an understanding of the transactions, determine whether the transactions have been approved by the board of directors or other appropriate officials, confirm the terms of the transactions with the related parties, evaluate the collectibility of any receivables outstanding, and evaluate the adequacy of disclosure of the details of the transactions in the notes to the financial statements.

⁵ When this procedure was performed in prior years, the auditors are able to consider the accuracy of the credit manager's previous responses in evaluating the reasonableness of the current responses.

Primary Audit Objectives:
Presentation ☒

Primary Audit Objectives:
Presentation ☒

Primary Audit Objectives:	
Valuation	☒
Accuracy	☒
Presentation	☒

Primary Audit Objectives:	
Presentation	☒

Interim Audit Work on Receivables and Revenue

14. Evaluate the Business Purpose of Significant and Unusual Sales Transactions.

As the auditors perform the audit of revenue and receivables, they will be alert for significant and unusual transactions. In fact, certain procedures are specifically directed at discovering such transactions, for example, the analytical and data analytic procedures described previously. Auditors are required to evaluate the business purpose of any transaction that comes to their attention that is significant and unusual. Such transactions may be indicative of fraudulent financial reporting.

15. Evaluate Financial Statement Presentation and Disclosure of Receivables and Revenue.

The auditors should determine that the financial presentation of accounts and notes receivable and the related disclosures are in accordance with generally accepted accounting principles. Related party receivables should be shown separately with disclosure of the nature of the relationships and the amounts of the transactions. Any unusual terms of notes receivable should be disclosed in the notes. Also, the amounts of allowances for uncollectible receivables should be shown as deductions from the related receivables. Finally, significant concentrations of credit risk arising from trade accounts receivable should be disclosed in accordance with FASB ASC 310-10-50.

Much of the audit work on receivables and revenue can be performed one or two months before the balance sheet date. The **interim audit work** may consist of the consideration of controls, evaluation of the client's accounting methods, and, in some cases, the confirmation of accounts receivable as well. A decision to carry out the confirmation of receivables at an interim date rather than at year-end is justified only if the risk of material misstatement for existence of accounts receivable is low.

If interim audit work has been done on receivables and revenue, the year-end audit work may be modified considerably. For example, if the confirmation of accounts receivable was performed at October 31, the year-end audit plan would include preparation of a summary analysis of postings to the Accounts Receivable controlling account for the period from November 1 through December 31. This analysis would list the postings by month, showing the journal source of each. These postings would be traced to the respective journals, such as the sales journal and cash receipts journal. The amounts of the postings would be compared with the amounts in preceding months and with the corresponding months in prior years. The purpose of this work is to identify any significant variations in receivables during the months between the interim audit work and the balance sheet date.

In addition to this analysis of the entries to the receivable accounts for the intervening period, the audit work at year-end would include obtaining the aging of the accounts receivable at December 31, confirmation of any large accounts in the year-end trial balance that are new or delinquent, and the usual investigation of the year-end cutoff of sales and cash receipts.

Chapter Summary

In this chapter, we described the details of controls over receivables and revenue, the auditors' consideration of these controls, and substantive procedures for the receivables and revenue accounts. To summarize:

1. The audit of receivables and revenue represents significant audit risk because (a) many incidences of financial statement fraud have involved the overstatement of receivables and revenue, (b) revenue recognition may be based on complex accounting rules, and (c) receivables and revenue are usually subject to valuation using significant accounting estimates. Companies should establish effective high-level controls over the financial reporting of these accounts, including (a) effective board of directors and audit committee oversight of the reporting of revenue; (b) an internal audit department to monitor compliance with other revenue cycle controls; (c)

policies to attract, develop, and retain competent employees that apply controls, including those that determine revenue and receivables estimates; and (d) effective monitoring policies and procedures. In addition, a sound accounting system and effective control activities should be established for the revenue cycle.

2. The revenue cycle includes the receiving of orders from customers, the delivery and billing of goods and services, and the recording and collection of accounts receivable. Effective internal control over sales transactions is best achieved by having separate departments responsible for preparing sales orders, approving credit, shipping merchandise, billing customers, maintaining the accounts receivable subsidiary ledger, and authorizing adjustments to sales and accounts receivable.
3. The auditors' assessment of the risks of material misstatement is used to determine the nature, timing, and extent of substantive procedures for the assertions related to receivables and revenue. If the audit plan includes an expectation of the operating effectiveness of controls, the auditors must design and perform tests of controls.
4. The primary objectives for the auditors' substantive procedures for receivables and revenue are to (a) substantiate the existence of receivables and the occurrence of revenue transactions, (b) establish the completeness of receivables and revenue, (c) verify the cutoff of revenue transactions, (d) determine that the client has rights to the recorded receivables, (e) establish the proper valuation of receivables and the accuracy of revenue transactions, and (f) establish that the presentation and disclosure of receivables and revenue are appropriate.
5. The most time-consuming and critical audit procedures for receivables and revenue are those designed to test the assertions of existence, occurrence, and valuation. Among the procedures designed to achieve these objectives is confirmation of accounts receivable, which is generally required in audits. Acknowledgment of the debt provides evidence of the existence of receivables and the occurrence of sales, as well as the gross valuation of the amounts. An important part of obtaining evidence about the proper valuation of accounts receivable is the auditors' evaluation of the adequacy of the allowance for uncollectible accounts. Because this account is a management estimate, it is typically audited by a combination of inquiry of management, analytical procedures, inspection of various documents, and auditor professional judgment assessing the reasonableness of the account.
6. Other significant aspects of the audit include evaluation of the appropriateness of the client's methods of revenue recognition and procedures directed at identifying and evaluating the disclosure of related party transactions and receivables.

Key Terms Introduced or Emphasized in Chapter 11

Aged trial balance (530) A listing of individual customers' accounts classified by the number of days subsequent to billing, that is, by age. A preliminary step in estimating the collectibility of accounts receivable.

Bill and hold transactions (541) Transactions in which sales of merchandise are billed to customers prior to delivery, with the goods being held by the seller. These transactions may overstate revenues and net income if they do not meet specific requirements for recognition as sales.

Bots (535) Software applications that are programmed to do certain repetitive tasks.

Channel stuffing (541) A marketing practice that suppliers sometimes use to boost sales by inducing customers to buy substantially more inventory than they can promptly resell. Channel stuffing without appropriate provision for sales returns is an example of booking tomorrow's revenue today in order to window dress the financial statements.

Confirmation request (533) A request sent to a *confirming party* requesting that the confirming party consider the accuracy of information included in that request. A confirmation request may take one of two forms: *positive confirmation request* and *negative confirmation request*.

Confirming party (533) The individual who responds to the confirmation request. Responses to confirmation requests provide more relevant and reliable audit evidence when the confirmation requests are sent to confirming parties who the auditors believe are knowledgeable about the information to be confirmed. For example, an individual in accounts payable may provide more relevant and reliable audit evidence with respect to a client's receivable balance than an individual who has no direct access to accounts payable records.

Critical audit matter (CAM) (524) As included in the PCAOB auditing standards, a matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment.

External confirmation (533) Audit evidence obtained by the auditors as a direct written (or electronic) response (reply) to the auditors from a third party (the confirming party) in paper form or by electronic or other medium (e.g., the auditors' direct access to information held by a third party). The confirmation process may be viewed as (1) sending a confirmation request to the confirming party, (2) evaluating the written (or electronic) response, and (3) addressing nonresponses (and incomplete responses) from the confirming party.

Fidelity bond (513) A form of insurance protection that covers policyholders for losses that they incur as a result of fraudulent acts by specified individuals. Fidelity bonds usually insure a business for losses caused by the dishonest acts of its employees.

Interim audit work (548) Those audit procedures that are performed before the balance sheet date. The purpose is to facilitate earlier issuance of the audit report and to spread the auditors' work more uniformly over the year.

Management review controls (518) Reviews conducted by management of estimates and other kinds of financial information for reasonableness. They often involve the use of significant judgment, knowledge, and experience in comparing recorded amounts with expectations of the reviewers. They often are considered monitoring controls but may relate to any of the other COSO components that have the common characteristic of management review of information to identify misstatements or breakdowns in other controls.

Negative confirmation request (535) A request that the *confirming party* respond directly to the auditors indicating where the confirming party disagrees with the information in the request.

Pledging of receivables (547) To assign to a bank, factor, finance company, or other lender an exclusive claim against accounts receivable as security for a debt.

Positive confirmation request (535) A request that the *confirming party* respond directly to the auditor providing the requested information or indicating whether the confirming party agrees or disagrees with the information in the request.

Relevant assertions (524) An assertion about a class of transactions, account balance, or disclosure that has a reasonable possibility (its "likelihood") of being materially misstated (its "magnitude"). A relevant assertion is said to have "an identified risk of material misstatement." The determination of whether an assertion is a relevant assertion is made before considering any related controls (that is, the determination is based on inherent risk).

Risks of material misstatement (524) The risks that the financial statements are misstated. A risk of material misstatement exists when (a) there is a reasonable possibility of a misstatement occurring (that is, its likelihood) and (b) if it were to occur, there is a reasonable possibility of the misstatement being material (that is, its magnitude). The risks of material misstatement are addressed by auditors at the *financial statement level* and at the *assertion level*. At the *financial statement level*, it relates to risks that relate pervasively to the financial statement as a whole and potentially may affect many assertions. At the *assertion level*, it relates to specific assertions and consists of two components: inherent risk and control risk.

Side agreements (545) Formal or informal modifications of normal terms and conditions of sales transactions to entice customers to accept delivery of goods or services.

Significant risk (523) An identified risk of material misstatement that, in the auditors' judgment, requires special audit consideration due to their assessment of its inherent risk. The auditors consider the likelihood of misstatement occurring and the magnitude of the potential misstatement both as high. Using the terminology of the AICPA, it is "close to the upper end of the spectrum of inherent risk." Also, professional standards define specific circumstances that constitute significant risks related to revenue recognition and certain related party transactions (AU-C 240 and 550 and PCAOB AS 2110).

Window dressing (541) Action taken by the client shortly before the balance sheet date to improve the financial picture presented in the financial statements.

Review Questions

- 11-1. Explain the difference between a *customer's order* and a *sales order*, as these terms might be used by a manufacturing company making sales on credit.
- 11-2. Explain why the audit of revenue and receivables may present the auditors with significant audit risk.
- 11-3. An inexperienced clerk assigned to the preparation of sales invoices in a manufacturing company became confused as to the nature of certain articles being shipped, with the result that the prices used on the invoices were far less than called for in the company's price lists. What controls could be established to guard against such errors?
- 11-4. State briefly the objective of the billing process. What important document is created by the billing department?
- 11-5. Criticize the following statement: "Because the sales department maintains relationships with customers, personnel from that department should grant credit and decide when accounts should be written off as uncollectible."
- 11-6. The controller of a new client operating a medium-size manufacturing business complains to you that he believes the company has sustained significant losses on several occasions because certain sales invoices were misplaced and never recorded as accounts receivable. What control can you suggest to guard against such problems?
- 11-7. Comment on the following: "Any voided prenumbered shipping documents should be properly canceled and disposed of to eliminate any possibility of improper shipment of goods."
- 11-8. The accounts receivable section of the accounting department in Wind Power Inc. maintains subsidiary ledgers that are posted from copies of the sales invoices transmitted daily from the billing department. How may the accounts receivable section be sure that it receives promptly a copy of each sales invoice prepared?
- 11-9. Among specific procedures that contribute to good internal control over the business processes related to accounts receivable are (a) the approval of uncollectible account write-offs and credit memoranda by an executive and (b) the sending of monthly statements to all customers. State three other procedures conducive to strong internal control.
- 11-10. In the audit of an automobile agency, you find that installment notes received from the purchasers of automobiles are promptly discounted with a bank. Would you consider it necessary to confirm these notes by a communication with the bank? With the makers? Explain.
- 11-11. Your review of notes receivable from officers, directors, stockholders, and affiliated companies discloses that several notes of small amounts were written off to the allowance for uncollectible notes during the year. Have these transactions any special significance? Explain.
- 11-12. Assume you are auditing the financial statements of an information technology company that provides hardware and software to clients with complex sales contracts. Since the contracts are virtually identical, the company wants to use a portfolio approach to revenue recognition. Describe how the auditors might audit the consistency of contract terms (a) manually and (b) using artificial intelligence.
- 11-13. The confirmation of accounts receivable is an important auditing procedure. Should the formal request for confirmation be made by the client or by the auditors? Should the return envelope be addressed to the client, to the auditors in care of the client, or to the auditors' office? Explain.
- 11-14. State briefly the *audit objectives* that are addressed by the following audit procedure: "Confirm accounts receivable and notes receivable by direct communication with debtors."
- 11-15. In selecting accounts receivable for confirmation, the auditors discover that the client company's records show the addresses of many individual customers to be post office boxes. What should be the auditors' reaction to this situation?
- 11-16. Several accounts receivable confirmations have been returned with the notation, "Verification of vendors' statements are no longer possible because of our data processing system." What alternative auditing procedures could be used to verify these accounts receivable?
- 11-17. What alternative auditing procedures may be undertaken in connection with the confirmation of accounts receivable where customers having substantial balances fail to reply after second request forms have been mailed directly to them?
- 11-18. A CPA firm wishes to test the client's sales cutoff at June 30, 20X0. Describe the steps that the auditors should include in this test.

- 11-19. In your first audit of Hydro Manufacturing Company, a manufacturer of outboard motors, you discover that an unusually large number of sales transactions were recorded just before the end of the fiscal year. What significance would you attach to this unusual volume?
- 11-20. In connection with an audit, what are the purposes of a review of sales returns and allowances subsequent to the balance sheet date?
- 11-21. In the examination of credit memoranda covering allowances to customers for goods returned, how can the auditors ascertain whether the customer actually did return merchandise in each case in which accounts receivable were reduced?
- 11-22. Cite various procedures auditors employ that might lead to the detection of an inadequate allowance for doubtful accounts receivable.
- 11-23. Give an example of a type of receivable originating without arm's-length bargaining. Comment on the presentation of such receivables in the balance sheet.
- 11-24. Describe a retrospective review of an accounting estimate. With respect to the audit of revenue, what is the purpose of performing this review?

Questions Requiring Analysis

Select questions are available with Connect



LO 11-1, 4, 6

- 11-25. You have been assigned to the audit of Processing Solutions Inc., a privately held corporation that develops and sells computer systems. The systems are sold under one- to five-year contracts that provide for a fixed price for licensing, delivery, and setup of the systems and maintenance and technical support for the life of the contract. Your review of the working papers reveals that premature revenue recognition is a risk that must be addressed in the audit.
 - a. Summarize the guidance of the FASB regarding recognition of revenue on contracts.
 - b. Describe two techniques that management of Processing Solutions might use to overstate revenue.
 - c. For the two techniques identified in requirement (b), describe an auditing procedure that might be employed by the auditors to detect the overstatement of revenue.

LO 11-4, 6

- 11-26. Listed below are audit situations that may affect the audit of receivables and revenue.
 - a. The audit of a machinery manufacturing company that engages in bill and hold transactions.
 - b. The audit of a software company that engages in agreements with multiple performance obligations that involve a fixed fee for software, updates, and customer support.
 - c. The audit of a construction company that enters into long-term construction contracts.
 - d. The audit of a manufacturing company that uses complex sales agreements that allow product returns under certain circumstances.
 - e. The audit of a software company whose salespeople often modify the terms of sales contracts with various side agreements.

For each circumstance, provide an indication of its audit significance and any special audit procedures that would result.

LO 11-6

- 11-27. Hayden Corp. uses an enterprise resource planning (ERP) system. In their audit of receivables and revenues, the auditors have identified the following data elements in the corporation's database that may be used for data analytics applications:
 - Customer balance
 - Customer credit limit and credit rating
 - Customer total annual sales
 - Customer purchases by date
 - Customer returns by date
 - Customer name
 - Customer shipping address
 - a. Describe two data analytic applications that might be used to audit the existence of receivables and occurrence of sales.
 - b. Describe one data analytic application that might be used to audit the valuation of receivables.

- LO 11-6** 11-28. In their work on accounts receivable and elsewhere in an audit, the independent auditors often make use of confirmation requests.
- What is an audit confirmation request?
 - What characteristics should an audit confirmation response possess if a CPA firm is to consider it to be valid evidence?
 - Distinguish between a positive confirmation request and a negative confirmation request in the auditors' examination of accounts receivable.
 - In confirming a client's accounts receivable, what characteristics should be present in the accounts if the CPA firm is to use negative confirmations?
- LO 11-6** 11-29. During preliminary conversations with a new staff assistant, you instruct her to send out confirmation requests for both accounts receivable and notes receivable. She asks whether the confirmation requests should go to the makers of the notes or to the holders of the notes, in the case of notes that have been discounted. Provide an answer to her question and give reasons for your answer.
- LO 11-6** 11-30. Lakeside Company has retained you to conduct an audit so that it will be able to support its application for a bank loan with audited financial statements. The president of Lakeside states that you will have unlimited access to all records of the company and may carry out any audit procedures you consider necessary, except that you are not to communicate with customers. The president feels that contacts with customers might lead them to believe that Lakeside is in financial difficulty. Under these circumstances, will it be possible for you to issue the auditors' standard unqualified audit report? Explain.
- LO 11-2, 6** 11-31. During the audit of Solar Technologies Inc., the auditors sent confirmation requests to customers whose accounts had been written off as uncollectible during the year under audit. An executive of Solar protested, saying, "You people should be verifying that the receivables on the books are collectible. We know the ones we wrote off are no good."
- What purpose, if any, is served by this audit procedure?
 - Does the Solar executive's statement suggest some misunderstanding of audit objectives? Explain.
- LO 11-6** 11-32. Walter Conn, CPA, is engaged to audit the financial statements of Bingo Wholesaling for the year ended December 31, 20X0. Conn obtained and documented an understanding of the client and its environment, including internal control over the business processes relating to accounts receivable. He assessed the risks of material misstatement for all of the assertions about accounts receivable at a moderate level. Conn requested and obtained from Bingo an aged accounts receivable schedule listing the total amount owed by each customer as of December 31, 20X0.
- What additional substantive audit procedures should Conn consider applying in auditing the accounts receivable?
- LO 11-2, 5, 6** 11-33. An assistant auditor was instructed to "test the aging of accounts receivable as shown on the schedule prepared by the client." In making this test, the assistant traced all past-due accounts shown on the trial balance to the details in the accounts receivable subsidiary ledger and computed the aging of these accounts. The assistant found no discrepancies and reported to the senior auditor that the aging work performed by the client was satisfactory. Comment on the logic and adequacy of this test of the aging of accounts receivable.
- LO 11-1, 4** 11-34. You have been assigned to the audit of Utopia Industries Inc. for the year ended December 31, 20X1. The company makes components for communications and defense applications. To obtain an understanding of the methods of revenue recognition used by such businesses and the risks involved, you decide to review the SEC filings of other companies in the same industry.
- Use the Internet to search the SEC's EDGAR (Electronic Data Gathering and Retrieval System) for the 10-Ks of two companies that are in Utopia's industry (Standard Industrial Classification Code—3812—Search, Detection, Navigational, Guidance, Aeronautical Systems). The URL for EDGAR is www.sec.gov/edgar.shtml. You can obtain a list of these companies by searching for the SIC 3812. Use the "Search for Company Filings" button to get to the search screen. The first search option will allow you to search on SIC Codes.
 - Review the notes to the financial statements of the two companies and summarize their methods of revenue recognition.
 - Describe the audit risks that are inherent in the methods of revenue recognition used by the companies.



- LO 11-4, 6** 11-35. Hale Nelson, CPA, is engaged to audit the financial statements of Hollis Manufacturing Inc. Hollis engages in very complex sales agreements that create issues with respect to revenue recognition. As a result, Nelson has identified revenue recognition as an audit area of significant risk that requires special audit consideration.
- Describe the implications of Nelson's identification of revenue recognition as an area of significant risk.
 - Describe how Nelson might decide to react to the significant risk related to revenue recognition.

- LO 11-3, 5, 6** 11-36. Assume you are testing the internal controls over sales transactions for the Tidwell Co. audit. You have tested the general controls and found them to be operating effectively. You are now testing the application controls over sales transactions and have been provided with two data files.

Sales Transactions File

Customer No.	Sales Invoice No.	Date Shipped	Shipping Document No.	ID of Salesperson Authorizing Sale	Gross Invoice Amt	Invoice Date	Invoice Paid Flag

Customer File

Customer No.	Customer Name	Customer Address	Credit Limit	ID of personnel Approving Credit

- Describe three tests of controls that you might perform using data analytics.
- Assume that you discover a large number of sales that are not supported with shipping documents. What is the implication of this finding?

Objective Questions

LO 11-4

- 11-37. **Multiple Choice Questions**
Select the best answer for each of the following and explain fully the reason for your selection.

- Which of the following is *least* likely to be considered an inherent risk relating to receivables and revenues?
 - Restrictions placed on sales by laws and regulations.
 - Decline in sales due to economic declines.
 - Decline in sales due to product obsolescence.
 - Over-recorded sales due to a lack of control over the sales entry function.

LO 11-3, 6

- Which of the following would provide the most assurance concerning the valuation of accounts receivable?
 - Trace amounts in the accounts receivable subsidiary ledger to details on shipping documents.
 - Compare receivable turnover ratios to industry statistics for reasonableness.
 - Inquire about receivables pledged under loan agreements.
 - Assess the allowance for uncollectible accounts for reasonableness.

LO 11-1, 4, 5

- Which of the following is most likely to be an example of fraudulent financial reporting relating to sales?
 - Inaccurate billing due to a lack of controls.
 - Lapping of accounts receivable.
 - Misbilling a client due to a data input error.
 - Recording sales when the customer is likely to return the goods.

LO 11-1, 4

- Which of the following is an example of misappropriation of assets relating to sales?
 - Accidentally recording cash that represents a liability as revenue.
 - Holding the sales journal open to record next year's sales as having occurred in the current year.
 - Intentionally recording cash received from a new debt agreement as revenue.
 - Theft of cash register sales.

- LO 11-6** e. The auditors should confirm accounts receivable *unless* the auditors' assessment of the risk of material misstatement is low:
- (1) And accounts receivable are immaterial, or the use of confirmations would be ineffective.
 - (2) And accounts receivable are composed of large accounts.
 - (3) And the effectiveness of confirmations is absolutely determined.
 - (4) Or accounts receivable are from extremely reputable customers.
- LO 11-1** f. Under SEC rules, which of the following is *not* among the criteria that ordinarily exist for revenue to be recognized?
- (1) Collectibility is reasonably assured.
 - (2) Delivery has occurred or is scheduled to occur in the near future.
 - (3) Persuasive evidence of an arrangement exists.
 - (4) The seller's price to the buyer is fixed or determinable.
- LO 11-2, 5, 6** g. To determine that all sales have been recorded, the auditors would select a sample of transactions *from* the:
- (1) Shipping documents file.
 - (2) Sales journal.
 - (3) Accounts receivable subsidiary ledger.
 - (4) Remittance advices.
- LO 11-3, 4, 6** h. Which of the following would most likely be detected by an auditor's review of the client's sales cutoff?
- (1) Excessive goods returned for credit.
 - (2) Unrecorded sales discounts.
 - (3) Lapping of year-end accounts receivable.
 - (4) Inflated sales for the year.
- LO 11-2, 3, 6** i. To test the existence assertion for recorded receivables, the auditors would select a sample *from* the:
- (1) Sales orders file.
 - (2) Customer purchase orders.
 - (3) Accounts receivable subsidiary ledger.
 - (4) Shipping documents (bills of lading) file.
- LO 11-2, 3, 6** j. Which assertion relating to sales is most directly addressed when the auditors compare a sample of shipping documents to related sales invoices?
- (1) Existence or occurrence.
 - (2) Completeness.
 - (3) Rights and obligations.
 - (4) Presentation and disclosure.
- LO 11-2, 6** k. Cooper, CPA, is auditing the financial statements of a small rural municipality. The receivable balances represent residents' delinquent real estate taxes. Internal control at the municipality is weak. To determine the existence of the accounts receivable balances at the balance sheet date, Cooper would most likely:
- (1) Send positive confirmation requests.
 - (2) Send negative confirmation requests.
 - (3) Examine evidence of subsequent cash receipts.
 - (4) Inspect the internal records, such as copies of the tax invoices that were mailed to the residents.
- LO 11-2, 6** l. Identify the control that is most likely to prevent the concealment of a cash shortage resulting from the improper write-off of a trade account receivable:
- (1) Write-offs must be approved by a responsible official after review of credit department recommendations and supporting evidence.
 - (2) Write-offs must be approved by the accounts receivable department.
 - (3) Write-offs must be authorized by the shipping department.
 - (4) Write-offs must be supported by an aging schedule showing that only receivables overdue by several months have been written off.

LO 11-6 11–38. Adapted AICPA Task-Based Simulation

For each of the procedures described in the table below, identify the audit procedure performed and classification of the audit procedure using the following:

Audit Procedures:

- (1) Analytical procedure
- (2) Confirmation
- (3) Inquiry
- (4) Inspection of records or documents
- (5) Inspection of tangible assets
- (6) Observation
- (7) Recalculation
- (8) Reperformance

Classification of Audit Procedure:

- (9) Substantive procedures
- (10) Test of controls

Procedure	Audit Procedure	Classification of Audit Procedure
a. Requested responses directly from customers as to amounts due.		
b. Compared total bad debts this year with the totals for the previous two years.		
c. Questioned management about likely total uncollectible accounts.		
d. Watched the accounting clerk record the daily deposit of cash receipts.		
e. Examined invoice to obtain evidence in support of the ending recorded balance of a customer.		
f. Compared a sample of sales invoices to credit files to determine whether the customers were on the approved customer list.		
g. Examined a sample of sales invoices to see if they were initialed by the credit manager indicating credit approval.		

LO 11-6 11–39. Adapted AICPA Task-Based Simulation

You are involved with the audit of Jelco Company for year 1 and have been asked to consider the confirmation response indicated below. For each confirmation response, select the proper action to be taken from the following possible actions:

- (1) Exception; propose an adjustment.
- (2) Send a second confirmation request to the customer.
- (3) Examine shipping documents and/or subsequent cash receipts.
- (4) Verify whether the additional invoices noted on the confirmation response pertain to the year under audit or the subsequent year.
- (5) Not an exception; no further audit work is necessary.

Customer Response (and any audit action already taken)	Proper Action
a. "We mailed the check for this on December 31."	
b. "We returned those goods on December 2." You have been able to determine that the goods were received by the client on December 29, but not recorded until January 2.	
c. "We also owe for two more invoices for purchases we made around year-end; I'm not sure of the exact date."	
d. "We are very satisfied with Jelco and plan to purchase from them in the future."	
e. "While that's what we owe, we didn't owe it on December 31 because we didn't receive the goods until January 2 of year 2."	
f. You received no response to a negative confirmation request to Adams Co.	
g. You received no response to a positive confirmation request to Blake Co. Subsequently you recalled that Blake Co. has a policy of not responding to confirmations—in writing or orally.	

LO 11-4, 5 11–40. **Simulation**

An auditor's working papers include the following narrative description of the cash receipts and billing portions of Southwest Medical Center's internal control. Evaluate each condition following the narrative as being either (1) a strength, (2) a deficiency, or (3) not a strength or a deficiency.

Southwest is a health care provider that is owned by a partnership of five physicians. It employs 11 physicians, including the five owners; 20 nurses; five laboratory and X-ray technicians; and four clerical workers. The clerical workers perform such tasks as reception, correspondence, cash receipts, billing, accounts receivable, bank deposits, and appointment scheduling. These clerical workers are referred to as office manager, clerk #1, clerk #2, and clerk #3. Assume that the narrative is a complete description of the system.

About two-thirds of Southwest's patients receive medical services only after insurance coverage is verified by the office manager and communicated to the clerks. Most of the other patients pay for services by cash or check when services are rendered, although the office manager extends credit on a case-by-case basis to about 5 percent of the patients.

When services are rendered, the attending physician prepares a prenumbered service slip for each patient and gives the slip to clerk #1 for pricing. Clerk #1 completes the slip and gives the completed slip to clerk #2 and a copy to the patient.

Using the information on the completed slip, clerk #2 performs one of the following three procedures for each patient:

- Clerk #2 files an insurance claim and records a receivable from the insurance company if the office manager has verified the patient's coverage, or
- Clerk #2 posts a receivable from the patient on clerk #2's PC if the office manager has approved the patient's credit, or
- Clerk #2 receives cash or a check from the patient as the patient leaves the medical center, and clerk #2 records the cash receipt.

At the end of each day, clerk #2 prepares a revenue summary.

Clerk #1 performs correspondence functions and opens the incoming mail. Clerk #1 gives checks from insurance companies and patients to clerk #2 for deposit. Clerk #2 posts the receipt of patients' checks on clerk #2's PC patient receivable records and insurance companies' checks to the receivables from the applicable insurance companies. Clerk #1 gives mail requiring correspondence to clerk #3.

Clerk #2 stamps all checks "for deposit only" and each day prepares a list of checks and cash to be deposited in the bank. (This list also includes the cash and checks personally given to clerk #2 by patients.) Clerk #2 keeps a copy of the deposit list and gives the original to clerk #3.

Clerk #3 personally makes the daily bank deposit and maintains a file of the daily bank deposits. Clerk #3 also performs appointment scheduling for all of the doctors and various correspondence functions. Clerk #3 also maintains a list of patients whose insurance coverage the office manager has verified.

When insurance claims or patient receivables are not settled within 60 days, clerk #2 notifies the office manager. The office manager personally inspects the details of each instance of nonpayment. The office manager converts insurance claims that have been rejected by insurance companies into patient receivables. Clerk #2 records these patient receivables on clerk #2's PC and deletes these receivables from the applicable insurance companies. Clerk #2 deletes the patient receivables that appear to be uncollectible from clerk #2's PC when authorized by the office manager. Clerk #2 prepares a list of patients with uncollectible balances and gives a copy of the list to clerk #3, who will not allow these patients to make appointments for future services.

Once a month, an outside accountant posts clerk #2's daily revenue summaries to the general ledger, prepares a monthly trial balance and monthly financial statements, accounts for prenumbered service slips, files payroll forms and tax returns, and reconciles the monthly bank statements to the general ledger. This accountant reports directly to the physician who is the managing partner.

All four clerical employees perform their tasks on PCs that are connected through a local area network. Each PC is accessible with a password that is known only to the individual employee and the managing partner. Southwest uses a standard software package that was acquired from a software company and that cannot be modified by Southwest's employees. None of the clerical employees are able to write checks on the company's account.

For each of the following conditions, indicate whether they represent an internal control "strength" or "deficiency." If the condition is not an internal strength or deficiency, respond that the condition is "neither."

Conditions

- a. Southwest is involved only in medical services and has not diversified its operations.
- b. Insurance coverage for patients is verified and communicated to the clerks by the office manager before medical services are rendered.
- c. The physician who renders the medical services documents the services on a prenumbered slip that is used for recording revenue and as a receipt for the patient.
- d. Cash collection is centralized in that clerk #2 receives the cash (checks) from patients and records the cash receipt.
- e. Southwest extends credit rather than requiring cash or insurance in all cases.
- f. The office manager extends credit on a case-by-case basis rather than using a formal credit search and established credit limits.
- g. The office manager approves the extension of credit to patients and also approves the write-offs of uncollectible patient receivables.
- h. Clerk #2 receives cash and checks and prepares the daily bank deposit.
- i. Clerk #2 maintains the accounts receivable records and can add or delete information on the PC.
- j. Prenumbered service slips are accounted for on a monthly basis by the outside accountant, who is independent of the revenue-generating and revenue-recording functions.
- k. The bank reconciliation is prepared monthly by the outside accountant, who is independent of the revenue-generating and revenue-recording functions.
- l. Computer passwords are only known to the individual employees and the managing partner, who has no duties in the revenue-recording functions.
- m. Computer software cannot be modified by Southwest's employees.
- n. None of the employees who perform duties in the revenue-generating and revenue-recording functions are able to write checks.

LO 11-1, 2, 3, 4, 5 11-41. **Simulation**

An assistant on the Carter Company audit has been working in the revenue cycle and has compiled a list of possible errors and fraud that may result in the misstatement of Carter Company's financial statements and a corresponding list of controls that, if properly designed and implemented, could assist in preventing or detecting the errors and fraud.

For each possible error and fraud numbered *a* through *o*, select one internal control from the following answer list that, if properly designed and implemented, most likely could assist management in preventing or detecting the errors and fraud. Each response in the list of controls may be selected once, more than once, or not at all.

Controls

A. Shipping clerks compare goods received from the warehouse with the details on the shipping documents. B. Approved sales orders are required for goods to be released from the warehouse. C. Monthly statements are mailed to all customers with outstanding balances. D. Shipping clerks compare goods received from the warehouse with approved sales orders. E. Customer orders are compared with the inventory master file to determine whether items ordered are in stock. F. Daily sales summaries are compared with control totals of invoices. G. Shipping documents are compared with sales invoices when goods are shipped. H. Sales invoices are compared with the master price file. I. Customer orders are compared with an approved customer list. J. Sales orders are prepared for each customer order. K. Control amounts posted to the accounts receivable ledger are compared with control totals of invoices.	L. Sales invoices are compared with shipping documents and approved customer orders before invoices are mailed. M. Prenumbered credit memos are used for granting credit for goods returned. N. Goods returned for credit are approved by the supervisor of the sales department. O. Remittance advices are separated from the checks in the mailroom and forwarded to the accounting department. P. Total amounts posted to the accounts receivable ledger from remittance advices are compared with the validated bank deposit slip. Q. The cashier examines each check for proper endorsement. R. Validated deposit slips are compared with the cashier's daily cash summaries. S. An employee, other than the bookkeeper, periodically prepares a bank reconciliation. T. Sales returns are approved by the same employee who issues receiving reports evidencing actual return of goods.
-

Possible Errors and Fraud

- a. Invoices for goods sold are posted to incorrect customer accounts.
- b. Goods ordered by customers are shipped, but are **not** billed to anyone.
- c. Invoices are sent for shipped goods, but are not recorded in the sales journal.
- d. Invoices are sent for shipped goods and are recorded in the sales journal, but are **not** posted to any customer account.
- e. Credit sales are made to individuals with unsatisfactory credit ratings.
- f. Goods are removed from inventory for unauthorized orders.
- g. Goods shipped to customers do **not** agree with goods ordered by customers.
- h. Invoices are sent to allies in a fraudulent scheme and sales are recorded for fictitious transactions.
- i. Customers' checks are received for less than the customers' full account balances, but the customers' full account balances are credited.
- j. Customers' checks are misappropriated before being forwarded to the cashier for deposit.
- k. Customers' checks are credited to incorrect customer accounts.
- l. Different customer accounts are each credited for the same cash receipt.
- m. Customers' checks are properly credited to customer accounts and are properly deposited, but errors are made in recording receipts in the cash receipts journal.
- n. Customers' checks are misappropriated after being forwarded to the cashier for deposit.
- o. Invalid transactions granting credit for sales returns are recorded.

LO 11-6 11-42.**Simulation**

An auditor may use confirmations of accounts receivable. Reply as to whether the following statements are correct or incorrect with respect to the confirmation process when applied to accounts receivable.

- a. The confirmation requests should be mailed to respondents by the CPAs.
- b. A combination of positive and negative request forms must be used if receivables are significant.
- c. Second requests are ordinarily sent for positive form confirmation requests when the first request is not returned.
- d. Confirmations address existence more than they address completeness.
- e. Confirmation of accounts receivable is a generally accepted auditing standard.
- f. The auditors ordinarily should confirm accounts receivable.
- g. Auditors should always confirm the total balances of accounts rather than individual portions (e.g., if the balance is made up of three sales, all three should be confirmed).
- h. Auditors may ignore individually immaterial accounts when confirming accounts receivable.
- i. The best way to evaluate the results of the confirmation process is to compare the total misstatements identified to the account's tolerable misstatements amounts.
- j. Accounts receivable are ordinarily confirmed on a standard form developed by the American Institute of Certified Public Accountants and the Financial Executives Institute.

LO 11-1, 2, 4, 5 11-43.**Simulation**

The auditors have determined that each of the following objectives will be a part of the audit of SSC Corporation. While several procedures will ordinarily address an audit objective, select the procedure most directly related to the audit objective. Each procedure may be used once, more than once, or not at all.

Audit Objectives are to obtain sufficient appropriate audit evidence that:

- a. All receivables that should be recorded are recorded as of year-end.
- b. Recorded receivables are at appropriate net realizable values.
- c. Recorded receivables exist.
- d. The client has rights to recorded year-end receivables.
- e. The presentation and disclosure of receivables are adequate.

Audit Procedures

- (1) Compare the recorded receivable total with recorded payables.
- (2) Obtain an understanding of the business purpose of transactions that resulted in accounts receivable balance.
- (3) Review drafts of financial statements including disclosures.

- (4) Review board of director minutes for approval of each customer's credit limits.
- (5) Review the aged trial balance for significant past due accounts.
- (6) Trace a sample of purchase invoices from the purchases journal to postings to accounts receivable and sales accounts.
- (7) Trace a sample of sales invoices from late in December to the sales journal and to postings in accounts receivable and sales accounts.
- (8) Vouch year-end accounts receivable balances to supporting documents.

LO 11-6, 9-5 11-44.**Document Review Simulation**

This simulation, also available online, presents the Memo re Sales Invoice Procedures/Results relating to the Keystone Computers & Networks Inc. (Keystone) audit. Background financial and other information on Keystone is included in Appendix 6C of Chapter 6. *Callouts 1–4 of this simulation relate most directly to Chapters 10 and 11; Callouts 5–7 require knowledge of sampling, as presented in Chapter 9.*

A staff member on your audit team has performed a portion of the audit plan for the audit of Keystone Computers & Networks Inc., a nonissuer. The procedures involved selecting a random sample of sales invoices from throughout the year and comparing them to the authorized customer list and to appropriate support related to the sale (Exhibit 1). As senior on the engagement, you will now review various points made by the assistant. Background financial and other information on Keystone is included in Appendix 6C of Chapter 6.

DOCUMENT**Memo re Keystone Sales Invoice Procedures/Results****1/22/year 6**

A number of the credit sales in our sample were to customers not on the authorized customers list (Exhibit 1, fifth column). Selling to unauthorized customers may increase the risk that receivables will not be collectible. Accordingly, to address this issue, I suggest that we test for year-end receivables to unauthorized customers that remain uncollected as of the end of January. For those not collected, we should corroborate that the client has taken its normal 2 percent estimate for credit losses. (*Callout #1*)

Keystone in some circumstances ships sales FOB destination and pays the freight (see Exhibit 3). Because title ordinarily passes on such goods when they are delivered, there is a possibility that some sales have been recorded prior to the passage of title. Accordingly, we should increase the scope of our audit plan by selecting a sample of sales shipped FOB Shipping Point shortly after year-end to determine that the sale is recorded in the period goods were received by the customer. (*Callout #2*) Our sample results (Exhibit 1) reveal two sales recorded in year 5 that should have been recorded in year 6. (*Callout #3*)

A billing clerk (Exhibit 4) informed us that in several cases, sales were not recorded (completeness). Based on the discussion, an effective audit procedure to address this would be to select a sample of invoices sent to customers and agree their details to the underlying customer purchase order and shipping document. (*Callout #4*)

As a part of the audit of sales to unauthorized customers (above, top paragraph), we selected a sample of 40 sales invoices and found that three in our sample were to unauthorized customers. As indicated above, Exhibit 1 details our sample; Exhibit 2 presents results relating to the sample. The most likely deviation rate in the population is 5 percent (*Callout #5*). The sample results in "rejection" because the achieved upper deviation rate exceeds the sample deviation rate (*Callout #6*). Because we do not intend to expand our sample, the most likely effect on our audit will be a decrease in the assessed level of control risk (*Callout #7*) for the related assertion(s).

CALLOUT LIST #1*Choose an option below*

- a. [Original text] For those not collected, we should corroborate that the client has taken its normal 2 percent estimate for credit losses.
- b. [Delete text.]
- c. For those collected, we should corroborate that the client decreases the allowance for doubtful accounts.
- d. We should age all uncollected accounts as of year-end, paying particular attention to those to unauthorized customers to estimate likely doubtful accounts.
- e. It seems appropriate to double the client's normal 2 percent estimate for credit losses for sales to the unauthorized customers.
- f. As a conservative approach, we should propose journal entries writing off all uncollected accounts from unauthorized customers.

CALLOUT LIST #2*Choose an option below*

- a. [Original text] Shipping Point shortly after year-end to determine that the sale is recorded in the period goods were received by the customer.
- b. [Delete text.] [Delete entire sentence.]
- c. Destination shortly prior to year-end to determine that sale is recorded in the period goods were received by the customer.
- d. Shipping Point shortly prior to year-end to determine that the sale is recorded in the period goods were received by the customer.
- e. Destination shortly after year-end to determine that the sale is recorded in the period goods were received by the customer.

CALLOUT LIST #3*Choose an option below*

- a. [Original text] two sales recorded in year 5 that should have been recorded in year 6.
- b. eight sales recorded FOB Destination that should have been recorded in year 5.
- c. many sales recorded FOB Shipping Point that appear to have been recorded in year 5 but should have been recorded in year 6.
- d. no sales recorded in year 5 that should have been recorded in year 6.

CALLOUT LIST #4*Choose an option below*

- a. [Original text] invoices sent to customers and agree their details to the underlying customer purchase order and shipping document.
- b. authorized customers and compare their purchases as recorded in the purchases journal to the sales journal.
- c. shipping documents and determine that related sales have been recorded in the sales journal.
- d. recorded sales and determine that shipping documents exist.
- e. unauthorized customers and determine that sales to them are at the authorized amount.

CALLOUT LIST #5*Choose an option below*

- a. [Original text] 5 percent
- b. 7.5 percent
- c. 10.00 percent
- d. 15 percent
- e. 18.3 percent

CALLOUT LIST #6*Choose an option below*

- a. [Original text] sample deviation rate
- b. expected deviation rate
- c. materiality
- d. risk of assessing control risk too low
- e. tolerable deviation rate

CALLOUT LIST #7*Choose an option below*

- a. [Original text] assessed level of control risk
- b. planned level of control risk
- c. expected deviation rate
- d. assessed level of detection risk
- e. planned level of detection risk
- f. assessed risk of deviation

EXHIBITS

1. Sales Invoice Sample (Excel Sales Invoices file)
2. Sample Inputs and Results (Excel Sales Invoices file)
3. Conversation with Controller Memo
4. Conversation with Billing Clerk Memo

Exhibit 1

Sales Invoice Sample			Authorized		Shipping Document			Delivery Advice	
			Customer List	Sales Journal					
			Authorized Customer	Recorded in Sales Journal				Invoice Sent to Customer	Details of Documents* Agree
Invoice No.	Purchaser	Date	Amount		Date Shipped	Terms	Date Delivered		
10239	Marvella Menefee	1/04/year 5	4,557.60	Y	1/04/year 5	FOB Shipping	1/06/year 5	Y	Y
10379	Wingo Corp.	1/19/year 5	13,539.94	Y	1/19/year 5	FOB Shipping	1/20/year 5	Y	Y
10403	Lola Incorp.	1/19/year 5	854.51	N ✓	1/19/year 5	FOB Shipping	1/21/year 5	Y	Y
10410	Charolette Granderson	1/22/year 5	1,151.59	Y	1/22/year 5	FOB Shipping	1/27/year 5	Y	Y
10478	Rufus Leeks	2/09/year 5	13,144.44	Y	2/09/year 5	FOB Shipping	2/11/year 5	Y	Y
10495	Helena McGuigan	2/10/year 5	10,846.72	Y	2/10/year 5	FOB Dest	2/15/year 5	Y	Y
10526	Ling Incorp.	2/18/year 5	2,558.47	Y	2/18/year 5	FOB Shipping	2/20/year 5	Y	Y
10565	Isidro Durrance	2/18/year 5	7,679.81	Y	2/18/year 5	FOB Shipping	2/21/year 5	Y	Y
10620	Williams Plant Spec.	2/18/year 5	5,782.62	Y	2/18/year 5	FOB Shipping	2/20/year 5	Y	Y
10735	Chae Nicolosi	2/23/year 5	594.77	Y	2/23/year 5	FOB Shipping	2/24/year 5	Y	Y
10737	Helena McGuigan	2/23/year 5	2,748.76	Y	2/23/year 5	FOB Shipping	2/26/year 5	Y	Y
10768	Ernesto Emigh	3/03/year 5	12,371.50	Y	3/03/year 5	FOB Shipping	3/07/year 5	Y	Y
10822	Jennifer Jones Jeans	3/17/year 5	8,289.44	Y	3/17/year 5	FOB Shipping	3/19/year 5	Y	Y
10869	Jone Board	3/29/year 5	7,672.66	Y	3/29/year 5	FOB Shipping	4/03/year 5	Y	Y
10877	Terrell Rufener	4/07/year 5	300.33	Y	4/07/year 5	FOB Shipping	4/12/year 5	Y	Y
10919	Hectors Hinklo Corp.	4/25/year 5	12,509.57	Y	4/25/year 5	FOB Shipping	4/28/year 5	Y	Y
10940	Mary Hagwood	5/31/year 5	9,755.97	Y	5/31/year 5	FOB Shipping	6/02/year 5	Y	Y
10961	Shar Oil	6/03/year 5	12,875.53	N ✓	6/03/year 5	FOB Shipping	6/08/year 5	Y	Y

(continued)

Authorized Customer List										
Sales Invoice Sample				Sales Journal				Shipping Document		Delivery Advice
Invoice No.	Purchaser	Date	Amount	Authorized Customer	Recorded in Sales Journal	Date Shipped	Terms	Date Delivered	Details of Documents*	
									Invoice Sent to Customer	Agree
11006	Sherryl Eisberry	6/04/year 5	12,884.30	Y	6/06/year 5	6/04/year 5	FOB Dest	6/17/year 5	Y	Y
11061	Alysa Mgf.	6/14/year 5	250.23	N ✓	6/14/year 5	6/14/year 5	FOB Dest	6/19/year 5	Y	Y
11120	Monet Eady	6/19/year 5	4,748.74	Y	6/19/year 5	6/19/year 5	FOB Dest	6/20/year 5	Y	Y
11184	Adams Mart	6/22/year 5	3,298.92	Y	6/22/year 5	6/22/year 5	FOB Shipping	6/24/year 5	Y	Y
11224	Tory Vargas	7/18/year 5	14,821.84	Y	7/18/year 5	7/18/year 5	FOB Shipping	7/23/year 5	Y	Y
11227	Keira Dion	7/28/year 5	3,816.34	Y	7/28/year 5	7/28/year 5	FOB Shipping	8/12/year 5	Y	Y
11250	Smith Inc.	8/09/year 5	14,770.15	Y	8/10/year 5	8/09/year 5	FOB Shipping	8/13/year 5	Y	Y
11297	Laraine Peralta	8/11/year 5	4,831.41	Y	8/11/year 5	8/11/year 5	FOB Shipping	8/15/year 5	Y	Y
11309	Charles' Inc.	9/10/year 5	936.97	Y	9/10/year 5	9/10/year 5	FOB Shipping	9/14/year 5	Y	Y
11324	Joycelyn Huber	10/05/year 5	8,024.79	Y	10/05/year 5	10/05/year 5	FOB Shipping	10/08/year 5	Y	Y
11369	Lesli Matamoros	10/17/year 5	13,268.00	Y	10/17/year 5	10/17/year 5	FOB Shipping	10/21/year 5	Y	Y
11485	Blanchard Co.	10/21/year 5	3,676.32	Y	10/21/year 5	10/21/year 5	FOB Shipping	10/24/year 5	Y	Y
11486	Wingdoll, Corporation	10/27/year 5	3,744.02	Y	10/27/year 5	10/27/year 5	FOB Dest	10/31/year 5	Y	Y
11499	Genesis Beliefs	11/04/year 5	11,364.69	Y	11/04/year 5	11/04/year 5	FOB Dest	11/08/year 5	Y	Y
11526	Charolette Granderson	11/05/year 5	2,074.39	Y	11/05/year 5	11/05/year 5	FOB Dest	11/08/year 5	Y	Y
11602	Thomas Mo.	11/07/year 5	2,681.88	Y	11/07/year 5	11/07/year 5	FOB Dest	11/12/year 5	Y	Y
11696	Anastacia Italiano	11/13/year 5	2,120.18	Y	11/13/year 5	11/13/year 5	FOB Shipping	11/18/year 5	Y	Y
11775	Lloyd Sumrell	12/18/year 5	1,330.95	Y	12/18/year 5	12/18/year 5	FOB Shipping	12/22/year 5	Y	Y
11779	Williams Co.	12/22/year 5	8,760.84	Y	12/22/year 5	12/22/year 5	FOB Shipping	12/24/year 5	Y	Y
11925	Cristobal Posada	12/25/year 5	12,747.04	Y	12/25/year 5	12/25/year 5	FOB Shipping	1/02/year 6	Y	Y
11961	Junie Denison	12/28/year 5	1,536.08	Y	12/28/year 5	12/28/year 5	FOB Shipping	12/31/year 5	Y	Y
11982	Wellington Assoc.	12/29/year 5	11,412.25	Y	12/29/year 5	12/29/year 5	FOB Shipping	1/03/year 6	Y	Y

* As per audit plan, details of sales journal, sales invoice, shipping document, and invoice agree.

✓ Customer not on approved customer list.

Exhibit 2

Sample Inputs and Results

Attribute	Sales to Unauthorized Customers
Risk of Assessing Control Risk Too Low	5%
Expected Deviation Rate	5%
Tolerable Deviation Rate	15%
Sample Size	40
Results	
Deviations	3
Sample Deviation Rate	7.5%
Achieved Upper Deviation Rate	18.3%
Decision	Reject

Exhibit 3**Conversation with Controller Memo**

I spoke with the controller on this issue of FOB Shipping Point versus FOB Destination freight. She informed me that a decision is made based on the likelihood of losing the client if the client is expected to pay the freight.

Thus, if customer X isn't all that steady of a customer, particularly a customer who uses other suppliers, the company then offers the term FOB Destination and does not charge the customer for the freight.

She also pointed out that the policy is beginning to cause a few problems as several customers have brought up the topic that they "heard" that not everyone had to pay the freight. She indicated that she told those customers that such shipping only occurred in rare and unexpected circumstances.

Although her response seems to understate the FOB Destination issue, I pass further review of it.
Audit Assistant

Exhibit 4**Conversation with Billing Clerk Memo**

I spoke with the Billing Clerk, who helped me organize my thoughts about Keystone's billing system. The company always bills the day that it ships items to customers. Generally, the customer pays for the shipping, although this is not always the case.

When I asked him if there have been any "difficulties" during the year, he mentioned that in a few situations, goods had been shipped and no invoice had been prepared for the shipment, and accordingly, no sales journal entry had been prepared until the company discovered the problem, once when a customer returned the goods and several times when customers asked about billing. He assured me that the problem had been rectified and that he believed there were no more such transactions. (A new employee had been involved who didn't completely understand the electronic process.)

Audit Assistant

Problems

LO 11-4, 6

- 11-45. Halston Toy Manufacturing Co. introduced a number of new products in the last quarter of the year. The company has a liberal return policy allowing retail customers to return products within 120 days of purchase.

- Describe the audit problem indicated by this scenario.
- List audit procedures that could be used to audit the allowance for sales returns.

LO 11-3, 4, 5, 6

- 11-46. The following are typical questions that might appear on an internal control questionnaire for accounts receivable:

- Are sales invoices checked for proper pricing, terms, and clerical accuracy?
- Are shipping documents prenumbered and all numbers accounted for?

3. Is customer credit approval obtained from the credit department prior to shipment of goods?
 - a. Describe the purpose of each of the above controls.
 - b. Describe the manner in which the operating effectiveness of each of the above procedures might be tested.
 - c. Assuming that the operating effectiveness of each of the above procedures is found to be inadequate, describe how the auditors might alter their substantive procedures to compensate for the increased level of control risk (risk of material misstatement).

LO 11-1, 6 11-47. During your examination of the financial statements of Martin Mfg. Co., a new client, for the year ended March 31, 20X0, you note the following entry in the general journal dated March 31, 20X0:

Notes Receivable	550,000	
Land		500,000
Gain on sale of land		50,000
To record sale of excess plant-site land to Ardmore Corp. for 8 percent note due five years from date. No interest payment required until maturity of note.		

Your review of the contract for sale between Martin and Ardmore, your inquiries of Martin executives, and your study of the minutes of Martin's directors' meetings uncover the following facts:

- (1) The land has been carried in your client's accounting records at its cost of \$500,000.
- (2) Ardmore Corp. is a land developer and plans to subdivide and resell the land acquired from Martin Mfg. Co.
- (3) Martin had originally negotiated with Ardmore on the basis of a 12 percent interest rate on the note. This interest rate was established by Martin after a careful analysis of Ardmore's credit standing and current money market conditions.
- (4) Ardmore had rejected the 12 percent interest rate because the total outlay on a 12 percent note for \$550,000 would amount to \$880,000 at the end of five years, and Ardmore thought a total outlay of this amount would leave it with an inadequate return on the subdivision. Ardmore held out for a total cash outlay of \$770,000, and Martin Mfg. Co. finally agreed to this position. During the discussions, it was pointed out that the present value of \$1 due five years hence at an annual interest rate of 12 percent is approximately \$0.567.

Ignoring income tax considerations, is the journal entry recording Martin's sale of the land to Ardmore acceptable? Explain fully and draft an adjusting entry if you consider one to be necessary.

LO 11-1, 6 11-48. You are conducting an annual audit of Granite Corporation, which has total assets of approximately \$1 million and operates a wholesale merchandising business. The corporation is in good financial condition and maintains an adequate accounting system. Granite Corporation owns about 25 percent of the capital stock of Desert Sun Inc., which operates a dude ranch. This investment is regarded as a permanent one and is accounted for by the equity method.

During your audit of accounts and notes receivable, you uncover the information shown below concerning three short-term notes receivable due in the near future. All three of these notes receivable were discounted by Granite Corporation with its bank shortly before the balance sheet date.

1. A 13 percent 60-day note for \$50,000 received from a customer of unquestioned financial standing.
2. A 15 percent six-month note for \$60,000 received from the affiliated company Desert Sun Inc. The affiliated company is operating profitably, but it is presently in a weak cash position because of recent additions to buildings and equipment. The president of Granite Corporation intends to make an \$80,000 advance with a five-year maturity to Desert Sun Inc. The proposed advance will enable Desert Sun Inc. to pay the existing 15 percent \$60,000 note at maturity and to meet certain other obligations.
3. A 14 percent \$20,000 note from a former key executive of Granite Corporation whose employment had been terminated because of chronic alcoholism and excessive gambling. The maker of the note is presently unemployed and without personal resources.

Describe the proper balance sheet presentation with respect to these discounted notes receivable. Use a separate paragraph for each of the three notes, and state any assumptions you consider necessary.

- LO 11-1** 11-49. The July 31, 20X0, general ledger trial balance of Aerospace Contractors Inc. reflects the following accounts associated with receivables. Balances of the accounts are after all adjusting journal entries proposed by the auditors and accepted by the client.

Accounts receivable—commercial	\$ 595,000
Accounts receivable—U.S. government	3,182,000
Allowance for uncollectible accounts and notes	75,000 cr.
Claims receivable—public carriers	7,000
Claims receivable—U.S. government terminated contracts	320,000
Due from Harwood Co., investee	480,000
Notes receivable—trade	15,000

Remember that two or more ledger accounts are often combined into one amount in the financial statements in order to achieve a concise presentation. The need for brevity also often warrants the disclosure of some information parenthetically: for example, the amount of the allowance for doubtful accounts.

- Draft a partial balance sheet for Aerospace Contractors at July 31, 20X0. In deciding which items deserve separate listing, consider materiality as well as the nature of the accounts.
- Write an explanation of the reasoning employed in your balance sheet presentation of these accounts.

In-Class Team Case

LO 11-6



- 11-50. Ming, CPA, is engaged to audit the financial statements of Wellington Sales Inc. for the year ended December 31, 20X0. Ming obtained and documented an understanding of the client's business and environment, including internal control over business processes relating to accounts receivable. She assessed the risks of material misstatement for the assertions of existence, rights, and valuation of accounts receivable at a high level. Ming requested and obtained from Wellington an aged accounts receivable schedule listing the total amount owed by each customer as of December 31, 20X0, and sent positive confirmation requests (signed by Sam Blocker, the controller of Wellington). Ming has asked Zimmer, the staff assistant assigned to the engagement, to follow up on the nine returned confirmations that follow. Assume that each confirmation is material if the potential misstatement is projected to the population. Also, assume that in all cases the debit balance is the result of a credit to "Sales." In several circumstances, a "Note to files" is included with additional information relating to the confirmation.

Describe the procedure or procedures, if any, that Zimmer should perform to resolve each of the nine confirmations (below) with exceptions that were returned and, if possible, provide the audited value of the account. Assume that all amounts involved are considered material.

Confirmation #5

The statement of our account showing a balance of \$20,000 due Wellington Sales Inc. at December 31, 20X0, is correct except as noted below:

Abbington Co.
By Alfred Martin

Date: 1/16/X1

Exceptions: **Yes, we ordered \$20,000 worth of merchandise from Wellington in November. However, we mailed Wellington a check for \$20,000 on 12/18/X0.**

Note to files: Blocker indicates that the check was received and deposited on 12/28/X0 but posted to the wrong customer's account.

Confirmation #22

The statement of our account showing a balance of \$12,222 due Wellington Sales Inc. at December 31, 20X0, is correct except as noted below:

Wilson Dilco
By Kent Parry

Date: 2/2/X1

Exceptions: **No way. Forget it. Wellington said we'd have these goods in 10 days on December 2. When we didn't receive them, I canceled the order on December 12th. Wiggo Smiggo Corporation shipped us similar goods overnight. We'll never deal with Wellington again as long as I am around.**

Confirmation #47

The statement of our account showing a balance of \$22,000 due Wellington Sales Inc. at December 31, 20X0, is correct except as noted below:

The Big Edge
By Bert Quinton

Date: 1/22/X1

Exceptions: **We use a voucher system by individual invoice. We cannot verify the balance, but Wellington is one of our regular suppliers. We probably owe them something.**

Confirmation #51

The statement of our account showing a balance of \$75,000 due Wellington Sales Inc. at December 31, 20X0, is correct except as noted below:

Farkele Corporation of America and the World
By Robby Boertson

Date: 1/9/X1

Exceptions: **Our records show that we sent them a check for the amount due on 12/29/X0.**

Confirmation #62

The statement of our account showing a balance of \$2,500 due Wellington Sales Inc. at December 31, 20X0, is correct except as noted below:

Pibson Gonker Corporation
By Sam Sheffield

Date: 1/30/X1

Exceptions:

Note to files: This confirmation was returned by the postal service as "return to sender, address unknown."

Confirmation #68

The statement of our account showing a balance of \$66,000 due Wellington Sales Inc. at December 31, 20X0, is correct except as noted below:

Yanrarian Ruckus Company
By Tom Turken

Date: 2/7/X1

Exceptions: **We mailed that check for the full amount on 1/3/X1. The merchandise was not received until 12/23/X0.**

Confirmation #72

The statement of our account showing a balance of \$22,000 due Wellington Sales Inc. at December 31, 20X0, is correct except as noted below:

Yeg Co.
By Alfred Martin

Date: 1/30/X1

Exceptions: **Yes, I guess we owe this amount, but Wellington made clear to us that we could return any of the items we did not sell. But, so far, sales are good, and we've sold most of the items.**

Confirmation #77

The statement of our account showing a balance of \$32,000 due Wellington Sales Inc. at December 31, 20X0, is correct except as noted below:

Zell Incorporated
By John Nolan

Date: 1/19/X1

Exceptions: **We received \$24,000 worth of goods on consignment from Wellington on 2/10/X0, but they are not sold yet.**

Confirmation #79

The statement of our account showing a balance of \$42,000 due Wellington Sales Inc. at December 31, 20X0, is correct except as noted below:

Zentigton Corporation
By Wallace Olson

Date: 1/22/X1

Exceptions: **Yes, we ordered \$42,000 of merchandise on October 15, but Wellington was out of stock until recently. They seem to always be out of stock. We finally received the goods on January 4, 20X1.**

Ethics Cases

LO 11-1, 2, 6



- 11–51. You are an assistant audit or with Zaird & Associates, CPAs. Universal Air (UA), your fifth audit client in your eight months with Zaird, is a national airline based in your hometown. UA has continued to grow while remaining healthy financially over the eight years of its existence. Indeed, as you start the audit, you notice that (unaudited) sales are up 30 percent this year (20X1), with earnings up 40 percent. Your firm, Zaird & Associates, has been UA's only auditor.

During the audit you noticed that UA records sales when tickets are sold—debit receivable (or cash), credit sales. In performing substantive procedures relating to receivables, you also found that some of the “sales” are for 20X2 flights—generally in January and early February. You brought up this matter to your in-charge senior and she indicated that she also wondered about this last year when she worked on the audit. She suggested that she concluded that this isn't likely to be a problem for at least three reasons (any one of which would be sufficient to allow the current method):

1. The company has been using this approach since its inception eight years ago. Thus, any overstatement of this year's sales at year-end is likely to be “averaged out” by an understatement at the beginning of the year because the company followed the same policy last year (and the years before).
2. Valid reasons exist for including the sales when “booked.” The small airline's earnings process is probably best considered about complete when the sale is made because this is the toughest part of the revenue generation process. The planes are scheduled to fly for the first six months of next year, and will fly, regardless of whether these relatively few passengers who paid before year-end for next year's flights are on them; there are virtually no variable costs incurred for these passengers, except for a few very small bags of peanuts and a few cans of soda.
3. Imagine what a nightmare it would be to have to record an entry when a passenger buys a ticket, and then another one when the flight occurs.

She says she is willing to discuss this with you if you disagree, but at this point she thinks it isn't a problem.

- a. Discuss whether you agree or disagree with each of her reasons.

Now assume that you potentially agree with her first justification. You think that maybe a journal entry could be made at year-end to estimate the liability for next-year flights. Yet this wouldn't be necessary if everything does “average out” and any year-end liability is immaterial.

- b. Given this situation, would you expect the procedure to “average out” over the year?
c. How might one determine whether it does “average out” over the year?

LO 11-1, 5, 6

- 11–52. You have worked with Zaird & Associates, CPAs, for a little more than a year and are beginning your second audit of Universal Air (UA). This year you even have an assistant reporting to you—Jane McClain.

Jane has come to you with a concern. She noticed that when sales are “booked” over the Internet by credit charge, an entry is made debiting cash (from the credit card) and crediting air traffic liability. When the scheduled flight occurs, UA recognizes the revenue from the ticket. If a ticket is canceled on the Internet, the only entry made is to a database that maintains specific flight information on seat availability. Jane has discovered that customers are e-mailed a “Canceled Reservation” form when this occurs, but no accounting journal entry is recorded, and no refund occurs until the customer requests (in writing) a refund. If the customer never requests the refund, a credit to the individual's credit card account is never issued; when they do not get refunds on their credit cards, many customers complain and are given a refund, with an accompanying journal entry being made for the cancellation.

After analyzing the “Canceled Reservation” form, you note that it says nothing about requiring a written cancellation for a refund. UA's controller responded to your inquiry about

the policy of requiring a written request for a refund by indicating that the policy is presented on the website's "business policies and procedures" section. Furthermore, the controller says that in total about two-thirds of the customers ask for and receive refunds, while one-third do not. She then states to you that "the other one-third must not be aware of the policy, or simply don't care. What the heck, *caveat emptor!*"

At this point, you discussed the situation with Bill Radman, partner-in-charge of the audit. Subsequently, he made an inquiry of Zaird's attorneys about the legality of the policy, and received a response that while it is probably a questionable policy, they are unable to say it is illegal—in fact, it probably is not. Upon further investigation, you find that this policy has been in existence for three years (since your first year on the audit) and neither you nor anyone else in your firm has identified it previously.

- a. Is this a significant deficiency? Should it be reported to the audit committee?
- b. Should it be reported elsewhere? Where? How?
- c. What impact should this policy have on the audit?

Appendix 11A

Illustrative Audit Case: Keystone Computers & Networks Inc.

Part II: Consideration of Inherent and Control Risk

The second part of the audit case of Keystone Computers & Networks Inc. (KCN) illustrates the manner in which auditors assess inherent and control risk. The process is illustrated with the revenue and cash receipts cycle and includes the following working papers:

- ABC's working paper for the assessment of inherent risk for accounts receivable and revenue. (RSK-15)
- A questionnaire to document the control environment, risk assessment, and monitoring components of the company's internal control. Because this questionnaire is designed for nonpublic companies, it does not address factors that are generally found only in public companies, such as an audit committee of the board of directors. (IC-3)
- An organizational chart for the company. This working paper helps the auditors evaluate the overall segregation of functions within the company (IC-4).
- A description of internal controls. (IC-5)
- ABC's working paper for assessment of control risk for accounts receivable and revenue as it would appear before any tests of controls are performed. This working paper identifies the controls and deficiencies for the revenue and cash receipts cycle. It also relates the controls and deficiencies to the various financial statement assertions about revenue and accounts receivable. (IC 20 before completion)
- The audit plan for tests of controls for the revenue and cash receipts cycle. This working paper describes the various tests of controls that were performed by the staff of ABC to obtain evidence about the operating effectiveness of the controls. These tests provide the support for the auditors' assessed level of control risk. (IC 12 & 13)
- ABC's working paper documenting the results of tests of controls that were performed using audit sampling. (IC-15)
- ABC's working paper for assessment of control risk for accounts receivable and revenue as it would appear after all tests of controls are performed. Notice that the auditors have checked the boxes indicating that the controls are operating effectively. This allows ABC's staff to arrive at the final assessed level of control risk as indicated at the bottom of the working paper. (IC-20 completed)

You should read through the information to obtain an understanding of the way in which auditors document their assessment of inherent risk, understanding of internal control and assessment of control risk for a transaction cycle. You may also wish to review the planning documentation presented in Appendix 6C of Chapter 6 to refresh your knowledge about the nature of the company's business.

ASSESSING INHERENT RISK

Based on their understanding of the company and its environment, the auditors have developed their assessment of inherent risk for accounts receivable and revenue as documented in the following working paper.

KEYSTONE COMPUTERS & NETWORKS INC.
Assessment of Inherent Risk
12/31/X5

RSK-15
WL
10/15/X5

Inherent Risk Factor	Implications	Risk Level
Audited financial statements are required by Western Financial Services as a part of the company's line of credit agreement.	Management may be inclined to bias financial amounts. Therefore, there is a risk related to existence and occurrence of receivables and revenue, cutoff, and accuracy.	Moderate
KCN has engaged in a strategy to sell to customers with higher credit risk. In addition, the allowance for uncollectible accounts is a significant estimate requiring subjective judgment.	These are risks related to the adequacy of the allowance for uncollectible accounts (valuation).	High (Significant Risk)
The officers of the company receive significant bonuses based on quarterly results.	Management may intentionally overstate receivables or revenues. This risk relates to the existence and occurrence of receivables and revenue.	High (Significant Risk)
Revenue recognition on the sale of software is somewhat complex and involves estimation.	Revenue may be overstated due to misapplication of accounting or misestimation of revenue earned. This risk relates to the existence and occurrence of revenue.	High Risk

OBTAINING AND DOCUMENTING AN UNDERSTANDING OF THE REVENUE AND CASH RECEIPTS CYCLE

ABC's consideration of the controls relating to the revenue cycle began by updating various working papers, including the following:

- Control Environment, Risk Assessment and Monitoring Questionnaire-IC-3.
- Organizational Chart of KCN—IC-4.
- Description of Internal Controls—IC-5.
- Assessment of Control Risk Worksheet (before tests of controls are performed)—IC-20.⁶

The Control Environment, Risk Assessment, and Monitoring Questionnaire (IC-3), the Organizational Chart (IC-4) and the description of Internal Control—Sales and Collection Cycle (IC-5) required only limited updating because there were few changes in internal

⁶ This schedule is included twice (incomplete and complete) for illustrative purposes. In an actual audit, only the completed schedule would be included.

control during the year, and key personnel are the same as in the preceding year. After completing the description of internal control, the audit staff of ABC observed operation of the system and found that the controls had been placed in operation.

The staff of ABC then used the documentation of internal control to identify controls and deficiencies on Schedule IC-20. This schedule includes check boxes in the appropriate columns to designate the financial statement assertions that are addressed by the internal control policy or procedure. For the deficiencies, an “X” is included in the appropriate columns. Before tests of controls are performed, the check boxes are blank because the auditors do not know whether the controls are operating effectively.

Control Environment, Risk Assessment, and Monitoring Questionnaire—Nonpublic Companies

IC-3-1
WL
11/10/X5

Client: *Keystone Computers & Networks Inc.*

Financial Statement Date: *12/31/X5*

Control Environment	Yes	No	N/A	Comments
Management Philosophy and Operating Style				
1. Does management adequately consider the potential effects of taking large or unusual business risks prior to doing so?	☒	☐	☐	
2. Are business risks adequately monitored?	☒	☐	☐	
3. Is management not overly aggressive with respect to financial reporting?	☒	☐	☐	
4. Are financial statement estimates developed in a conscientious manner?	☒	☐	☐	
Organizational Structure				
5. Is the organization of the entity clearly defined in terms of lines of authority and responsibility?	☒	☐	☐	
6. Does the entity have a current organizational chart and related materials such as job descriptions?	☒	☐	☐	
7. Are policies and procedures for authorization of transactions established at an adequately high level?	☒	☐	☐	
8. Are such policies and procedures adequately adhered to?	☒	☐	☐	
Methods of Assigning Authority and Responsibility				
9. Are authority and responsibility to deal with organizational goals and objectives, operating functions, and regulatory requirements adequately delegated?	☒	☐	☐	
10. Has management established and communicated policies about appropriate business practices and conduct and conflicts of interest?	☒	☐	☐	
11. Are employees held accountable for internal control responsibilities?	☒	☐	☐	
Board of Directors, Independence, Integrity and Ethical Values, Commitment to Competence				
12. Is the level of experience, status, and independence of the members of the board of directors appropriate for the organization?	☒	☐	☐	
13. Are there regular meetings of the board of directors to set policies and objectives, review the entity's performance, and take appropriate action; and are minutes of such meetings prepared and signed on a timely basis?	☒	☐	☐	

Control Environment, Risk Assessment, and Monitoring Questionnaire—Nonpublic Companies

IC-3
WL
11/10/X5

Client: *Keystone Computers & Networks Inc.*

Financial Statement Date: 12/31/X5

Control Environment	Yes	No	N/A	Comments
Board of Directors, Independence, Integrity and Ethical Values, Commitment to Competence				
14. Has management taken adequate actions to reduce incentives and temptations that might prompt employees to engage in dishonest, illegal, and unethical acts?	☒	☐	☐	
15. Does management exhibit an adequate commitment to competence in the performance of essential jobs within the organization?	☒	☐	☐	
Human Resource Policies and Procedures				
16. Does the entity employ sound hiring practices, including background investigations, where appropriate?	☒	☐	☐	
17. Are employees adequately trained to meet their job responsibilities?	☒	☐	☐	
18. Is employee performance evaluated at regular intervals?	☒	☐	☐	
19. Are employees in positions of trust bonded?	☒	☐	☐	
20. Are employees in positions of trust required to annually take vacations and are their duties rotated while they are on vacation?	☒	☐	☐	
Risk Assessment				
21. Does management clearly specify objectives, identify risks, and assess and manage risks, including fraud risks?	☒	☐	☐	
22. Does management identify and assess changes that could impact internal control?	☒	☐	☐	
Monitoring				
23. Are key management personnel sufficiently involved with operations to monitor the effectiveness of internal controls?	☒	☐	☐	
24. Does management have a formal process for considering reportable conditions from external auditors?	☒	☐	☐	

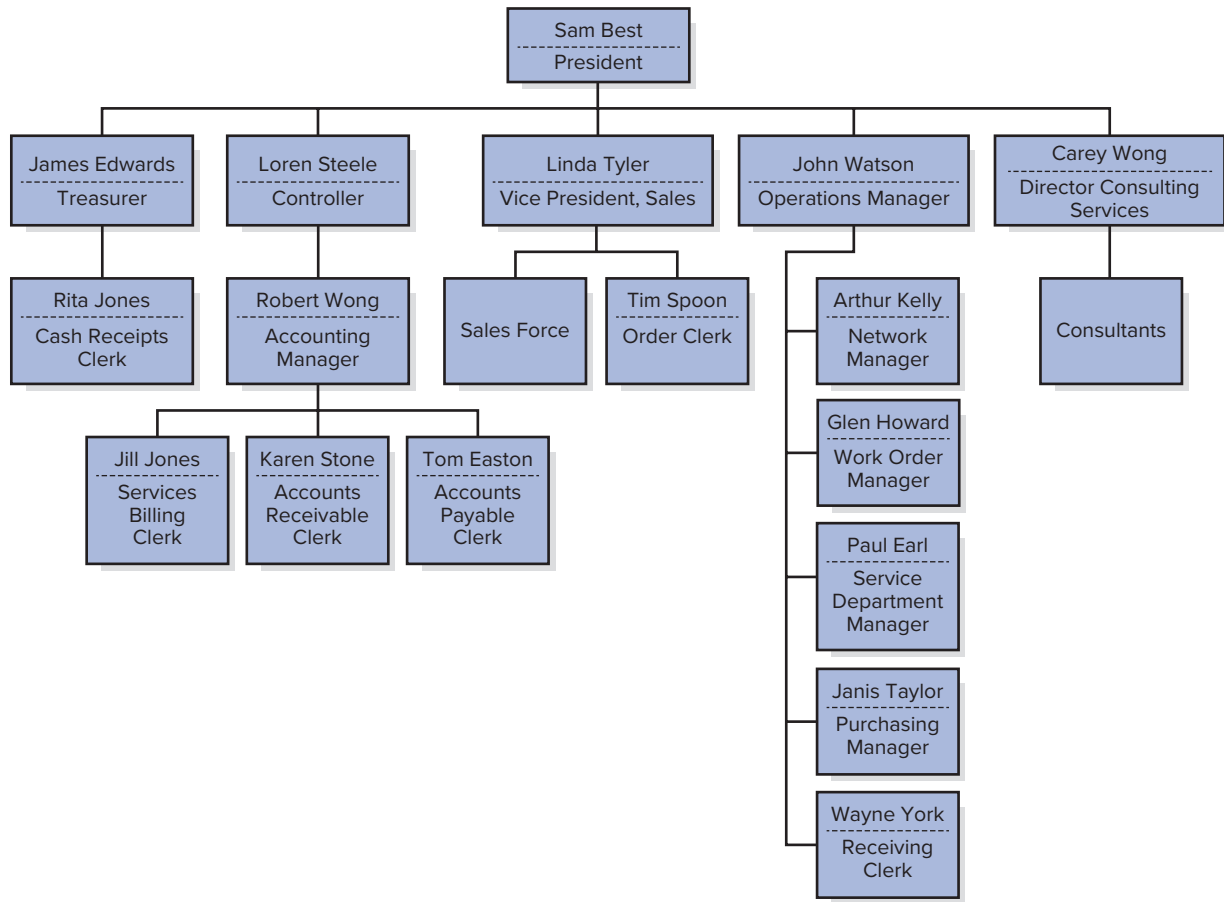
Evidence used to complete this questionnaire was obtained from discussions with the following individuals:

<i>Sam Best</i>	<i>11/8/X5</i>
<i>Linda Tyler</i>	<i>11/9/X5</i>
<i>James Edwards</i>	<i>11/9/X5</i>
<i>John Watson</i>	<i>11/9/X5</i>
<i>Loren Steele</i>	<i>11/10/X5</i>

Conclusion: *The control environment, risk assessment process, and monitoring procedures appear to be adequate to provide an atmosphere conducive to the effective operation of other controls.*

KEYSTONE COMPUTERS & NETWORKS INC.
Organizational Chart
12/31/X5

IC-4



TESTING CONTROLS AND ASSESSING CONTROL RISK

When obtaining an understanding of the overall internal control, ABC's audit staff first considered the elements of control environment, risk assessment, and monitoring as documented with the questionnaire (IC-3 and IC-3). As indicated on the questionnaire, they found these components to be strong for a nonpublic company and to reflect an atmosphere conducive to the effective operation of the accounting information system and control activities. The other controls over sales and collections are documented in IC-5.

Based on their understanding of internal control, ABC's staff planned assessed levels of control risk at a low level for completeness and at a moderate level for existence or occurrence, rights, and valuation. As with most small businesses, the auditors found that KCN had no effective controls to address the presentation and disclosure assertion. Based on the planned assessed levels, the audit staff of ABC designed a plan (IC-12 and IC-13) to test the controls. Schedule IC-15 illustrates how they determined sample size and evaluated the results of tests of controls that involved audit sampling.

The completed Schedule IC-20 includes check marks to indicate that the tests of controls demonstrated that the related controls were operating effectively. Based on these results, the auditors' assessed levels of control risk—indicated in the last row of Schedule IC-20—were supported at their planned levels. These assessments will be used in conjunction with the inherent risk assessments to determine the nature, timing, and extent of substantive procedures for revenue and accounts receivable. These tests are illustrated in Part III of the case in Appendix 11B.

Description of Internal Controls

1. The company uses Microsoft Dynamics GP, a commercial **ERP system** that has not been modified.
2. The company has a local area network, with computer terminals in the purchasing, work order, and accounting departments.
3. All consulting, license, and service contracts are reviewed by Loren Steele, controller.
4. Monthly service billings are reviewed for reasonableness by Loren Steele, controller.
5. Sales orders are entered on an online terminal that applies the following application controls:
 - The sales order clerk's password is verified before transactions can be inputted.
 - Customer numbers are agreed to customer master file information before transactions are accepted.
 - Computer evaluates whether the customer has sufficient credit limit remaining to make the purchase. If rejected, the customer's credit limit must be increased by the vice president—finance or the terms must be changed to cash on delivery.
 - Computer requires override of the transaction by the sales order clerk any time the sales price of an item is less than its cost.
 - Computer assigns number to sales invoice.
6. Shipping information is entered on an online terminal that applies the following controls:
 - The work order manager's password is verified before shipping data can be entered.
 - The shipping data are agreed to details of the sales transactions that were entered by the sales order clerk. If the name or number of the customer or the quantities shipped do not agree, the system will reject the data. Override will be accepted by the system only from the vice president of sales by password.
 - Computer assigns number to delivery receipt.
7. Cash receipts are entered to an online terminal that applies the following controls:
 - The accounts receivable clerk's password is verified before transactions can be entered.
 - When the customer number is entered, the company name is presented on screen for comparison by clerk.
8. As the computer updates the accounts receivable master file, it produces an exception report that contains any items with invalid customer numbers and any unusually large cash payments in relation to the customer's account balance. The accounting manager reviews and follows up on exceptions and any corrections are made the same day.
9. The accounting manager reconciles the master file of accounts receivable to the general ledger on a monthly basis.
10. Monthly statements are mailed to customers.
11. The receptionist endorses incoming checks "for deposit only" to the company's account and submits the checks to the cashier.
12. Cash sales are minor in amount and the cash is accepted by the receptionist, who maintains the company's cash fund.
13. Cash deposits are made daily by the cashier.
14. Computer summaries of cash collections of accounts receivable and cash sales are reconciled to validated bank deposit slips and the prelisting of cash receipts by the accounting manager.

15. Sales returns and allowances are approved by the vice president of sales.
16. Write-offs of accounts receivable are approved by the president after initiation by the controller, but not on a regular basis.
17. The accounting manager reconciles bank account on a monthly basis.

KEYSTONE COMPUTERS & NETWORKS INC.
Assessment of Control Risk—Revenue Cycle
12/31/X5

IC-20
WL
11/13/X5

Controls	Existence or Occurrence	Completeness	Cutoff	Rights	Valuation and Accuracy	Presentation and Disclosure
Sales						
1. Separation of duties for authorization, credit approval, shipping, and accounting for sales transactions.	☐	☐		☐	☐	
2. Company uses an unmodified commercial software package.	☐	☐		☐	☐	
3. Credit lines are approved by the president.					☐	
4. Service contracts and billings are reviewed by the controller.	☐	☐	☐	☐	☐	
5. Computer verifies the clerk's password before sales data can be entered.	☐			☐	☐	
6. Application controls (input validation checks) are applied to ensure the accuracy of the billing process.					☐	
7. Computer assigns numbers to sales invoices.		☐	☐			
8. Computer verifies the work order manager's password before shipping data can be entered.	☐			☐	☐	
9. Input validation checks are applied to shipping data as they are entered.					☐	
10. Computer assigns numbers to delivery receipts.		☐	☐			
11. Accounts receivable clerk matches invoices with delivery receipts and accounts for numerical sequences.		☐	☐			
12. Accounting manager reconciles the accounts receivable master file to the general ledger monthly.	☐	☐		☐	☐	
13. Monthly statements are mailed to customers.	☐	☐		☐	☐	

(continued)

KEYSTONE COMPUTERS & NETWORKS INC.
Assessment of Control Risk—Revenue Cycle
12/31/X5

IC-20
WL
11/13/X5

Controls	Existence or Occurrence	Completeness	Cutoff	Rights	Valuation and Accuracy	Presentation and Disclosure
Sales						
14. Sales returns and allowances are approved by the vice president of sales.					☐	
15. Separation of duties of custody of cash from records of cash receipts and accounts receivable.	☐			☐	☐	
16. Checks are prelisted and stamped with restrictive endorsement when received.	☐			☐	☐	
17. Application controls (input validation checks) are applied to ensure the accuracy of the recording of cash receipts.					☐	
18. Control totals are reconciled by the accounting manager.	☐	☐		☐	☐	
19. Exception reports are reviewed and followed up by the accounting manager.					☐	
20. Computer summaries of cash collections and cash sales are reconciled to bank deposits and prelisting of cash receipts by accounting manager.	☐	☐		☐	☐	
21. Accounting manager reconciles bank account on a monthly basis.	☐	☐		☐	☐	
Internal Control Weaknesses						
1. Sales invoices are prepared and mailed prior to delivery of goods.	X		X	X	X	
2. Accounts receivable are not written off on a regular basis.					X	
Planned Assessed Level of Control Risk	<i>Moderate</i>	<i>Low</i>	<i>Moderate</i>	<i>Moderate</i>	<i>Moderate</i>	<i>Maximum</i>

Audit Plan—Tests of Controls—Revenue Cycle

IC-12
WL
11/12/X5

Client: *Keystone Computers & Networks Inc.*

Financial Statement Date: 12/31/X5

Procedure	Performed by	
	Initials	Date
Sales Transactions		
1. Walk three product and three service transactions through sales processes to confirm our understanding as documented.	<u>WL</u>	<u>11/14/X5</u>
2. Agree billings for a sample of 25 consulting contracts to contract terms.	<u>WL</u>	<u>11/14/X5</u>
3. Observe and inquire about the segregation of duties for sales transactions.	<u>WL</u>	<u>11/15/X5</u>
4. Inspect documentation of the Microsoft Dynamics GP software package.	<u>WL</u>	<u>11/15/X5</u>
5. Inquire about the president's procedures for approving credit limits.	<u>WL</u>	<u>11/15/X5</u>
6. Observe the order clerk when entering customer orders and enter several test transactions to determine that		
a. Password must be entered to enter customer orders.	<u>MP</u>	<u>11/14/X5</u>
b. The system performs a validity check for the customer's number.	<u>MP</u>	<u>11/14/X5</u>
c. The system determines that the customer's credit limit is not exceeded.	<u>MP</u>	<u>11/14/X5</u>
d. The system compares sales price to cost of product and requires override when cost exceeds sales price.	<u>MP</u>	<u>11/14/X5</u>
7. Observe that the computer assigns numbers to sales invoices.	<u>MP</u>	<u>11/14/X5</u>
8. Review the sales invoice file with delivery reports attached to obtain evidence that all numbers are accounted for and all invoices have an attached delivery report..	<u>MP</u>	<u>11/14/X5</u>
9. Inquire about the accounting manager's procedures for reconciling the accounts receivable master file to the general ledger.	<u>WL</u>	<u>11/15/X5</u>
10. Observe the mailing of monthly statements.	<u>MP</u>	<u>1/6/X6</u>
11. Inquire about the procedures for approval of sales returns and allowances by the vice president of sales.	<u>WL</u>	<u>11/15/X5</u>

Audit Plan—Tests of Controls—Revenue Cycle

IC-13
WL
11/12/X5

Client: <i>Keystone Computers & Networks Inc.</i>

Financial Statement Date: <i>12/31/X5</i>

Procedure	Performed by	
	Initials	Date
Cash Receipts		
12. Walk three cash receipts through cash receipts processes to confirm our understanding as documented.	<u>WL</u>	<u>11/14/X5</u>
13. Observe and inquire about the segregation of duties for cash receipts.	<u>WL</u>	<u>11/15/X5</u>
14. Observe the prelisting and endorsement of checks by the receptionist.	<u>MP</u>	<u>11/13/X5</u>
15. Observe the accounts receivable clerk entering cash receipts to determine that		
a. Password must be entered to enter cash receipts.	<u>MP</u>	<u>11/14/X5</u>
b. Customer's name is shown on screen when customer number is entered.	<u>MP</u>	<u>11/14/X5</u>
16. Test the procedures for reconciling control totals from the accounts receivable plan as follows:		
a. Inquire about the procedures.	<u>WL</u>	<u>11/14/X5</u>
b. Select a sample of printouts of the control totals and inspect them for evidence of reconciliation. Use the following parameters:		
(1) Risk of assessing control risk too low—10%.		
(2) Tolerable deviation rate—7%.		
(3) Expected deviation rate—1%.	<u>WL</u>	<u>11/14/X5</u>
17. Test the procedures for review and follow up on the exception reports from the accounts receivable plan as follows:		
a. Inquire about the procedures.	<u>WL</u>	<u>11/14/X5</u>
b. Select a sample of exceptions reports and inspect them for evidence of follow-up on the exceptions. Use the following parameters:		
(1) Risk of assessing control risk too low—10%.		
(2) Tolerable deviation rate—10%.		
(3) Expected deviation rate—0%.	<u>WL</u>	<u>11/14/X5</u>
18. Test the procedures for reconciling the computer summary of cash collections and cash sales to the deposit slips and prelisting of cash receipts as follows:		
a. Inquire about the procedures.	<u>WL</u>	<u>11/14/X5</u>
b. Select a sample of the computer summaries and inspect them for evidence of reconciliation. Use the following parameters:		
(1) Risk of assessing control risk too low—10%.		
(2) Tolerable deviation rate—10%.		
(3) Expected deviation rate—1%.	<u>WL</u>	<u>11/14/X5</u>
19. Inquire about the procedures for reconciliation of bank accounts.	<u>WL</u>	<u>11/14/X5</u>
20. Inspect four bank reconciliations performed during the year.	<u>WL</u>	<u>11/14/X5</u>

KEYSTONE COMPUTERS & NETWORKS INC.
Attributes Sampling Summary—Revenue Cycle
December 31, 20X5

IC-15
WL
11/14/X5

Objectives of test: (1) To test the operating effectiveness of the procedures for reconciling control totals of computer run for updating accounts receivable; (2) to test the operating effectiveness of the procedures for review and follow-up on the exception reports from the computer run for updating accounts receivable; (3) to test the operating effectiveness of the procedures for reconciling the computer summary of cash collections and cash sales to the deposit slips and prelisting of cash receipts.

Test	Population	Size
1	Control total reports	234
2	Exception reports	234
3	Computer summaries of collections and cash sales	234

Sampling unit: Individual reports

Random selection procedure: Random number table

Risk of assessing control risk too low: 10 percent

	Planning Parameters			Sample Results	
	Tolerable Deviation Rate	Expected Deviation Rate	Sample Size	Number of Deviations	Achieved Maximum Rate
Attributes Tested:					
1. Existence of a reconciliation of control totals initialed by the accounting manager.	7%	1%	55	1	7%
2. Indication of disposition of exceptions initialed by the accounting manager.	10%	0%	22	0	10%
3. Existence of a reconciliation of cash collections and cash sales to prelisting and deposit slips initialed by the accounting clerk.	10%	1%	38	0	6.4%

Conclusion: The results support the assessment of control risk for completeness at a low level, and for existence, occurrence, cutoff, rights, valuation, and accuracy at a moderate level.

KEYSTONE COMPUTERS & NETWORKS INC.
Assessment of Control Risk—Revenue Cycle
12/31/X5

IC-20
WL
11/13/X5

Controls	Existence or Occurrence	Completeness	Cutoff	Rights	Valuation and Accuracy	Presentation and Disclosure
Sales						
1. Separation of duties for authorization, credit approval, shipping, and accounting for sales transactions.	☒	☒		☒	☒	
2. Company uses an unmodified commercial software package.	☒	☒		☒	☒	
3. Credit lines are approved by the president.					☒	
4. Service contracts and billings are reviewed by the controller.	☒	☒	☒	☒	☒	
5. Computer verifies the clerk's password before sales data can be entered.	☒			☒	☒	
6. Application controls (input validation checks) are applied to ensure the accuracy of the billing process.					☒	
7. Computer assigns numbers to sales invoices.		☒	☒			
8. Computer verifies the work order manager's password before shipping data can be entered.	☒			☒	☒	
9. Input validation checks are applied to shipping data as they are entered.					☒	
10. Computer assigns numbers to delivery receipts.		☒	☒			
11. Accounts receivable clerk matches invoices with delivery receipts and accounts for numerical sequences.		☒	☒			
12. Accounting manager reconciles the accounts receivable master file to the general ledger monthly.	☒	☒		☒	☒	
13. Monthly statements are mailed to customers.	☒	☒		☒	☒	
14. Sales returns and allowances are approved by the vice president of sales.					☒	
15. Separation of duties of custody of cash from records of cash receipts and accounts receivable.	☒			☒	☒	

KEYSTONE COMPUTERS & NETWORKS INC.
Assessment of Control Risk—Revenue Cycle
12/31/X5

IC-20
WL
11/13/X5

Controls	Existence or Occurrence	Completeness	Cutoff	Rights	Valuation and Accuracy	Presentation and Disclosure
Sales						
16. Checks are prelisted and stamped with restrictive endorsement when received.	✓			✓	✓	
17. Application controls (input validation checks) are applied to ensure the accuracy of the recording of cash receipts.					✓	
18. Control totals are reconciled by the accounting manager.	✓	✓		✓	✓	
19. Exception reports are reviewed and followed up by the accounting manager.					✓	
20. Computer summaries of cash collections and cash sales are reconciled to bank deposits and prelisting of cash receipts by accounting manager.	✓	✓		✓	✓	
21. Accounting manager reconciles bank account on a monthly basis.	✓	✓		✓	✓	
Internal Control Deficiencies						
1. Sales invoices are prepared and mailed prior to delivery of goods.	X		X	X	X	
2. Accounts receivable are not written off on a regular basis.					X	
Assessed Level of Control Risk	<i>Moderate</i>	<i>Low</i>	<i>Moderate</i>	<i>Moderate</i>	<i>Moderate</i>	<i>Maximum</i>
Assessed Level of Inherent Risk From IR 6	<i>High</i>	<i>Low</i>	<i>High</i>	<i>High</i>	<i>High</i>	<i>Low</i>
Combined Assessed Level of Risk of Material Misstatement	<i>High</i>	<i>Low</i>	<i>High</i>	<i>High</i>	<i>High</i>	<i>Moderate</i>

Appendix 11A Problems

LO 11-2, 5, 6

11A-1. A summary of the controls for the revenue and cash receipts cycle of Keystone Computers & Networks Inc. appears in this appendix.

- a. For the following three controls over sales, indicate one type of error or fraud that the control serves to prevent or detect. Organize your solution as follows:

Control	Error or Fraud Controlled
1. Application controls are applied when customer orders are entered by the sales order clerk.	
2. The computer assigns numbers to sales invoices when they are prepared.	
3. Monthly statements are mailed to customers.	

- b. For the following three controls over cash receipts, indicate one type of error or fraud that the control serves to prevent or detect. Organize your solution as follows:

Control	Error or Fraud Controlled
1. Cash receipts are prelisted by the receptionist.	
2. The accounting manager reconciles control totals generated by the accounts receivable computer program.	
3. The computer summaries of cash collections and cash sales are reconciled to prelistings of cash receipts and cash deposits by the accounting manager.	

- LO 11-4, 5, 6** 11A-2. As indicated on the control risk assessment working paper Schedule IC-20 (its last section prior to the Assessed Level of Control Risk), the auditors identified two weaknesses in internal control over the revenue cycle of KCN. Describe the implications of each of the two weaknesses in terms of the type of errors or fraud that could result.
- LO 11-1, 5, 6** 11A-3. As indicated on Schedule IC-15, the auditors decided to apply audit sampling to three controls for the revenue and cash receipts cycle.
- Describe the characteristic that a control must possess in order to be tested with audit sampling.
 - Assume that the auditors decided to use audit sampling to test the operating effectiveness of the procedures for matching sales invoices with delivery receipts. Determine the required sample size, using the following parameters.
 - Risk of assessing control risk too low—5 percent
 - Tolerable deviation rate—15 percent
 - Expected deviation rate—1 percent
 - Prepare a working paper similar to Schedule IC-15 documenting the planned audit procedure described in requirement (b).

Appendix 11B

Illustrative Audit Case: Keystone Computers & Networks Inc.

Part III: Substantive Tests—Accounts Receivable and Revenue

This part of the audit case illustrates the manner in which the auditors design substantive tests of balances. The substantive tests are illustrated for two accounts—receivables and revenue. This aspect of the audit is illustrated with the following audit documentation:

- ABC's risk assessment working paper that combines the auditors' assessments of inherent and control risks into an overall risk of material misstatement for the assertions.
- The substantive audit procedures for accounts receivable and revenue.
- The audit sampling plan for the confirmation of accounts receivable.

Adams, Barnes & Co.'s assessment of control risk is described in Part II of the audit case in Appendix 11A. To refresh your knowledge of the case, review that part as well as Part I in Appendix 6C of Chapter 6.

Ref	Description of Risk	Significant Risk?	Relevant Assertion(s)	Assessed Risks of Material Misstatement			Summary of Audit Approach	Ref
Item No.				Inherent	Control	Combined Risk of Material Misstatement		Audit Plan Step
Revenue—Receivables and Revenue—Overall Risks								
	Gross Receivables and Gross Revenue		Existence/ Occurrence/ Rights	High	Moderate	High	- Confirm receivables by PPS sample at 12/31/X5. - Use generalized audit software to test client records. - Perform extensive cutoff of sales. - Perform substantive analytical procedures.	B-6, Steps 1–7
		No	Completeness	Low	Low	Low		B-6, Step 3
		No	Cutoff	High	Moderate	High		B-6, Step 12
		No	Accuracy	High	Moderate	High		B-6, Step 14

Receivables and Revenue—Specifically Identified Risks								
1	Inherent Risk Considerations Audited financial statements are required by Western Financial Services as a part of the company's line of credit agreement.	No	Existence/ Occurrence	High	Moderate	High	During the brainstorming session, staff members were informed of the need to increase their professional skepticism regarding any matters that would increase the amount of net income. Also the ways of overstating revenue were discussed, including shipments or services not ordered or provided.	
2	Inherent Risk Considerations KCN has engaged in a strategy to sell to customers with higher credit risk. In addition, the allowance for uncollectible is a significant estimate requiring subjective judgment.	Yes	Valuation	High	Moderate	High	In Process	
3	Inherent Risk Considerations The officers of the company receive significant bonuses based on quarterly results.	Yes	Existence/ Occurrence	High	Moderate	High	In Process	
4	Inherent Risk Considerations Revenue recognition on software is complex and involves significant estimation.	Yes	Existence/ Occurrence	High	Moderate	High	In Process	

Audit Plan—Substantive Tests—Accounts Receivable and Revenues

B-6
WL
11/10/X5

Client: <i>Keystone Computers & Networks Inc.</i>

Financial Statement Date: <i>12/31/X5</i>

Procedure	Performed by	
	Initials	Date
Sales Transactions		
1. Obtain an aged trial balance of accounts receivable as of 12/31/X5.	<u>MP</u>	<u>1/6/X6</u>
2. Select a sample of customers' accounts at 12/31/X5 for positive confirmation using probability-proportional-to-size sampling based on the following parameters:		
a. Risk of incorrect acceptance of 5%.		
b. Tolerable misstatement of \$150,000.		
c. Expected misstatement of \$20,000.	<u>MP</u>	<u>1/7/X6</u>
3. Use generalized audit software to:		
a. Foot the master file of accounts receivable at 12/31/X5.	<u>MP</u>	<u>2/12/X6</u>
b. Test the client-prepared aging of accounts receivable.	<u>MP</u>	<u>1/7/X6</u>
c. Select the specific accounts for confirmation.	<u>MP</u>	<u>1/7/X6</u>
4. Mail accounts receivable confirmation requests.	<u>MP</u>	<u>1/8/X6</u>
5. Send second requests for all unanswered confirmation requests.	<u>MP</u>	<u>1/25/X6</u>
6. For confirmation requests to which no reply is received, perform the following alternative procedures:		
a. Test items subsequently paid to remittance advices that identify the specific invoices paid. If necessary, reconcile the amounts paid to sales invoices and delivery receipts.	<u>MP</u>	<u>2/16/X6</u>
b. For items not paid, inspect the invoices and delivery receipts for the sales transactions making up the account balance.	<u>MP</u>	<u>2/16/X6</u>
7. Resolve exceptions noted on confirmation requests.	<u>MP</u>	<u>2/16/X6</u>
8. Review credit files for customers with accounts receivable above \$150,000 at 12/31/X5. Investigate any indications of fictitious accounts.	<u>MP</u>	<u>2/16/X6</u>
9. Summarize the results of the confirmation procedures.	<u>MP</u>	<u>2/16/X6</u>

(continued)

Audit Plan—Substantive Tests—Accounts Receivable and Revenues**B-6
WL
11/10/X5***(Concluded)***Client:** *Keystone Computers & Networks Inc.***Financial Statement Date:** *12/31/X5*

Procedure	Performed by	
	Initials	Date
10. Review the adequacy of the allowance for uncollectible accounts by performing the following procedures:		
a. Review the aged trial balance of accounts receivable with the president.	<u>WL</u>	<u>2/13/X6</u>
b. Review confirmation exceptions for indications of disputed amounts.	<u>WL</u>	<u>2/13/X6</u>
c. Analyze and review trends in the following relationships:		
(1) Accounts receivable to net sales.	<u>WL</u>	<u>2/15/X6</u>
(2) Allowance for bad debts to accounts receivable.	<u>WL</u>	<u>2/15/X6</u>
(3) Bad debt expense to net sales.	<u>WL</u>	<u>2/15/X6</u>
11. At year-end, review the file of sales invoices that are waiting to be matched with delivery receipts for any sales transactions that were not executed and, therefore, should be recorded in the subsequent period.	<u>MP</u>	<u>12/31/X5</u>
12. For all sales recorded in the last week of the year, inspect the related delivery receipt to determine that the sale occurred before 12/31/X5.	<u>MP</u>	<u>2/12/X6</u>
13. Review credit memoranda for sales returns and allowances through the last day of fieldwork to determine if an adjustment is needed to record the items as of year-end.	<u>MP</u>	<u>2/16/X6</u>
14. Perform analytical procedures for sales and accounts receivable including comparison of the following to prior years and/or industry data:	<u>WL</u>	<u>2/12/X6</u>
a. Gross profit percentage by month.	<u>WL</u>	<u>2/12/X6</u>
b. Sales by month by salesperson.	<u>WL</u>	<u>2/16/X6</u>
c. Accounts receivable turnover.	<u>WL</u>	<u>2/16/X6</u>
d. Advertising expense as a percentage of sales.	<u>WL</u>	<u>2/16/X6</u>
e. Net receivables as a percentage of total current assets.	<u>WL</u>	<u>2/16/X6</u>
15. Ascertain whether any accounts have been assigned, pledged, or discounted by review of agreements and confirmation with banks.	<u>WL</u>	<u>2/13/X6</u>
16. Ascertain by inquiry whether any accounts are owed by employees or related parties such as officers, directors, or shareholders, and		
a. Obtain an understanding of the business purpose for the transactions that resulted in the balances.	<u>WL</u>	<u>2/16/X6</u>
b. Ascertain the amounts involved.	<u>WL</u>	<u>2/16/X6</u>
c. Confirm the balances.	<u>WL</u>	<u>1/25/X6</u>

KEYSTONE COMPUTERS & NETWORKS INC.
Audit Sample Plan for Confirmation of Accounts Receivable
12/31/X5

B-9
WL
1/7/X6

Objective: Establish the existence and gross valuation of accounts receivable and occurrence and accuracy of sales by confirmation.

Population: The trial balance of 933 uncollected sales invoices (accounts receivable) at 12/31/X5, with a total book value of \$10,235,457.

Definition of Misstatement: Any amount that is determined not to be a valid account receivable.

Sampling Technique: Probability-proportional-to-size.

Sampling Parameters:

1. Tolerable misstatement:

Total materiality as indicated in the audit plan	\$300,000
Less: Estimate of undetected misstatement (50% of overall materiality)	<u>-150,000</u>
Tolerable misstatement for this test	<u>\$150,000</u>

2. Risk of incorrect acceptance:

Because we have assessed the risk of material misstatement as high, the risk of incorrect acceptance will be set at 5 percent.

3. Expected misstatement:

Based on prior-year audits, the expected misstatement for the account is \$20,000.

Calculation of Sample Size and Sampling Interval:

$$\begin{aligned}
 \text{Sample size} &= \frac{\text{Book value of population} \times \text{Reliability factor}}{\text{Tolerable misstatement} - (\text{Expected misstatement} \times \text{Expansion factor})} \\
 &= \frac{\$10,235,457 \times 3.00}{\$150,000 - (\$20,000 \times 1.6)} \\
 &= 260 \\
 \text{Sampling interval} &= \frac{\text{Book value of population}}{\text{Sample size}} = \frac{\$10,235,457}{260} = \$39,400 \text{ (rounded)}
 \end{aligned}$$

Actual sample size was only 142 because a number of accounts were more than twice the sampling interval.

	KEYSTONE COMPUTERS & NETWORKS INC.						B-11 WL	
	Monthly Sales Report						1/9/X6	
	For the Three Years Ended 12/31/X5							
	Sales of Computers			Consulting Revenue			Service Revenue	
	20X3	20X4	20X5	20X3	20X4	20X5	20X3	20X5
January	3,348,340	3,479,482	3,268,584	3,626,893	3,521,682	3,180,808	342,440	307,519
February	3,365,453	3,692,918	3,593,775	4,145,019	3,519,281	3,328,754	369,309	348,522
March	3,667,774	3,782,262	3,781,385	3,857,171	3,849,059	3,772,588	369,310	378,522
April	3,741,928	3,638,318	3,176,864	3,799,601	3,802,120	3,402,726	372,440	359,525
May	3,810,378	3,628,391	3,360,305	3,914,740	3,708,240	3,513,685	376,180	348,522
June	3,747,632	3,797,153	3,727,187	3,799,601	3,942,939	4,105,463	399,610	389,174
July	3,884,532	3,484,446	3,318,613	4,202,589	3,708,240	3,550,671	396,180	348,874
August	3,873,124	3,742,554	3,568,760	3,972,310	4,083,758	3,772,588	368,810	348,522
September	3,850,307	3,980,806	3,885,613	3,914,740	3,942,939	4,290,394	389,510	409,525
October	3,998,615	3,792,190	3,160,187	4,317,728	4,083,758	3,883,546	421,750	369,274
November	4,186,852	3,841,826	3,539,576	4,202,589	4,271,517	4,179,435	385,780	348,874
December	4,203,965	4,030,442	3,964,826	4,145,019	4,318,457	4,697,241	376,580	368,924
Total	45,678,900	44,890,788	42,345,675	47,898,000	46,751,990	45,677,899	4,567,888	4,325,777

Note: Amounts were generated by ACL program from Keystone's general ledger.

Appendix 11B Problems

- 11B-1. In Part III (Appendix 11B) of the audit case, the audit staff of Adams, Barnes & Co. identified specific revenue risks on Schedule RA-12. However, the “Summary of Audit Approach” section is incomplete (in process) for risks 2 and 3.
- Review the audit plan Schedule B-6 and identify the substantive audit procedures that were designed specifically to address these risks of material misstatement.
- LO 11-4, 6** 11B-2. Assume that you have been assigned to the audit of Keystone after audit planning has occurred. Review the planning information in Appendix 6C of Chapter 6 and the audit plan for the accounts receivable and revenue (Schedule B-6). The manager on the engagement has given you the task of reviewing the monthly revenue report on Schedule B-11.
- Based on your review of the report, describe any unusual relationships that might indicate a risk of misstatement of revenues based on your knowledge of the company derived from a review of the information on Schedule B-12.
 - Identify any procedures on the audit plan for receivables and revenue that might address the risk(s) identified in part (a).
 - Design two other procedures that would address the risk(s) identified in part (a).
- LO 11-6** 11B-3. Keystone Computers & Networks Inc. (KCN) has 933 accounts receivable, with a total book value of \$10,235,457. From that population, Adams, Barnes & Co. (ABC), CPAs, selected a sample of 260 accounts (142 unique accounts) for confirmation for the year ended December 31, 20X5, as illustrated by the working paper in Schedule B-6. First and second confirmation requests resulted in replies for all but 10 of those accounts. ABC performed alternative procedures on those 10 accounts and noted no exceptions. Of the replies, five had exceptions as described below (with ABC follow-up):
- “The balance of \$120,000 is incorrect because we paid that amount in full on December 31, 20X5.” *Follow-up: An analysis of the cash receipts journal revealed that the check had been received in the mail on January 9, 20X6.*
 - “Of the balance of \$30,000, \$330 is incorrect because on December 19 we returned a printer to Keystone when we found that we didn’t need it. We ordered it in the middle of November when we had anticipated a need for it. When we received the printer, we realized it was unnecessary and returned it unopened.” *Follow-up: An analysis of the transaction revealed that it was received by Keystone on December 31, 20X5, and that the adjustment to the account had been processed on January 2, 20X6.*
 - “The balance of \$214,000 is correct, and we paid it on January 5, 19X6.” *Follow-up: An analysis of the cash receipts journal revealed that the check had been received on January 10, 20X6.*
 - “Of the balance of \$130,000, \$10,000 is incorrect because it represents goods that we didn’t receive until January 5, 20X6.” *Follow-up: Inspection of shipping records reveals that the item was shipped on January 3, 20X6.*
 - “Of the account’s \$18,000 balance, we paid \$17,460 and the \$540 (3 percent of the total) remains unpaid because the Keystone salesperson told us that she would be able to obtain a ‘special’ discount beyond the normal.” *Follow-up: While inspection of the sales agreement indicated no such discount arrangement, discussions with Loren Steele (controller) and Sam Best (president) indicated that the salesperson had inappropriately granted such a discount to the client. On January 15 of 20X6, they processed the discount and credited the account for \$540.*
 - For each of the five exceptions, determine the account’s proper “audited value.”
 - Use the probability-proportional-to-size method with your analysis from requirement (a) to evaluate your sample’s results. The risk of incorrect acceptance is 5 percent.

This problem includes additional parts that require the use of generalized audit software. See the Connect library or additional student resources (05_Idea Audit Sampling Exercises) for more information.

Inventories and Cost of Goods Sold

LO 12-1

Describe the nature of inventories and cost of goods sold.

The interrelationship of inventories and cost of goods sold makes it logical for the two topics to be considered together. The controls that assure the fair valuation of inventories are found in the purchases (or acquisition) cycle. These controls include procedures for selecting vendors, ordering merchandise or materials, inspecting goods received, recording the liability to the vendor, and authorizing and making cash disbursements. In a manufacturing business, the valuation of inventories also is affected by the production (or conversion) cycle, in which various manufacturing costs are assigned to inventories, and the cost of inventories is then transferred to the cost of goods sold.

The selection of an accounting method and the consistency of its application also affect the valuation of both inventories and cost of goods sold. During periods of inflation, limitations of historical cost affect the relevance of cost of goods sold as much as they affect inventories. Thus, it is not surprising that the Financial Accounting Standards Board (FASB) experimented with requiring supplemental disclosure of current replacement cost of inventories.¹ Although companies are no longer required to disclose this information, many companies include a discussion of the effects of inflation in “Management’s Discussion and Analysis of Financial Condition,” which is a required section of a company’s annual Form 10-K filed with the SEC.

Inventories and Cost of Goods Sold

Sources and Nature of Inventories and Cost of Goods Sold

The term *inventories* is used in this chapter to include (1) goods on hand ready for sale, whether the merchandise of a trading concern or the finished goods of a manufacturer; (2) goods in the process of production; and (3) goods to be consumed directly or indirectly in production, such as raw materials, purchased parts, and supplies.

The Auditors’ Objectives in Auditing Inventories and Cost of Goods Sold

LO 12-2

Describe the auditors’ objectives in the audit of inventories and cost of goods sold.

The auditors’ *objectives* in the audit of inventories and cost of goods sold are to

1. Use the understanding of the client and its environment to consider *inherent risks*, including fraud risks, related to inventories and cost of goods sold.
2. Obtain an understanding of *internal control* over inventories and cost of goods sold.
3. Assess the risks of material misstatement and design tests of controls and substantive procedures that
 - a. Substantiate the *existence* of inventories and the *occurrence* of transactions affecting cost of goods sold.
 - b. Establish the *completeness* of recorded inventories.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 12-1** Describe the nature of inventories and cost of goods sold.
- LO 12-2** Describe the auditors’ objectives in the audit of inventories and cost of goods sold.
- LO 12-3** Describe the documents, records, and accounts that are involved in the purchases and production (conversion) cycles and the fundamental controls over inventories, purchasing, and production.
- LO 12-4** Use the understanding of the client and its environment to consider inherent risks (including fraud risks) related to inventories, purchases, and cost of goods sold.
- LO 12-5** Obtain an understanding of internal control over inventories and cost of goods sold.
- LO 12-6** Assess the risks of material misstatement of inventories and cost of goods sold and design further audit procedures, including tests of controls and substantive procedures, to address the risks.

¹ The requirement for mandatory disclosure of current cost information was rescinded by *FASB Statement No. 89*, “Financial Reporting and Changing Prices.”

- c. Verify the *cutoff* of transactions affecting cost of goods sold.
- d. Determine that the client has *rights* to the recorded inventories.
- e. Establish the proper *valuation* of inventories and the *accuracy* of transactions affecting cost of goods sold.
- f. Determine that the *presentation* and *disclosure* of information about inventories and cost of goods sold are appropriate, including disclosure of the classification of inventories, accounting methods used, and inventories pledged as collateral for debt.

In conjunction with the audit of inventories and cost of goods sold, the auditors also will obtain evidence about the related purchases, sales, purchase returns, and sales returns accounts.

The responsibilities of independent auditors with respect to the validity of inventories can best be understood by considering the spectacular *McKesson & Robbins* fraud case. The hearings conducted by the SEC in 1939 disclosed that the audited financial statements of McKesson & Robbins Inc., a drug company listed on the New York Stock Exchange, contained \$19 million of fictitious assets, about one-fourth of the total assets shown on the balance sheet. The fictitious assets included \$10 million of nonexistent inventories. How was it possible for the independent auditors to have conducted an audit and to have issued an unqualified report without discovering this gigantic fraud? The audit plan followed for inventories in this case was in accordance with customary auditing practices of the 1930s. The significant point is that in that period, it was customary to limit the audit work on inventories to an examination of records only; the standards of that era did not require any **observation**, physical count, or other actual contact with the inventories.

Up to the time of the *McKesson & Robbins* case, auditors had avoided taking responsibility for verifying the accuracy of inventory quantities and the physical existence of the goods. With questionable logic, many auditors had argued that they were experts in handling figures and analyzing accounting records but were not qualified to identify and measure the great variety of raw materials and manufactured goods found in the factories, warehouses, and store buildings of their clients.

The *McKesson & Robbins* case brought a quick end to such limited views of the auditors' responsibilities. In 1939, *Statements on Auditing Procedures 1* and 2, the first formal auditing standards issued by the AICPA, affirmed the importance of the auditors' observation of physical inventories but authorized the substitution of other auditing procedures under certain circumstances. Auditing standards continue to distinguish between companies that determine inventory quantities solely by an annual physical count (**periodic inventory system**) and companies with a well-kept **perpetual inventory system**. The latter companies often have strong internal control over inventories and may employ sampling techniques to verify the records by occasional test counts throughout the year rather than by a complete annual count of the entire inventory. For those clients, the auditors' observation of physical inventory may be limited to such counts as they consider appropriate, and these counts may occur during or after the end of the period being audited.

The auditors' approach to the verification of inventories and cost of goods sold should be one of awareness of the possibility of fraud, as well as of the prevalence of accidental error in the determination of inventory quantities and amounts. Fraudulent misstatement of inventories often has been employed to evade income taxes, to conceal shortages arising from various illegal schemes, and to mislead creditors and stockholders or other inactive owners as to a company's profits and financial position.

Internal Control over Inventories and Cost of Goods Sold

The importance of adequate internal control over inventories and cost of goods sold from the viewpoint of both management and the auditors can scarcely be overemphasized. In some companies, management stresses controls over cash and securities but pays little attention to control over inventories. Because many types of inventories are composed of items not particularly susceptible to theft, management may consider controls to be unnecessary in this area. Such thinking ignores the fact that controls for inventories affect nearly all the functions involved in producing and disposing of the company's products.



Illustrative Case

Bid Rigging at Sheraton



The need for proper control over the purchasing function is dramatically illustrated by a case in which two buyers for the Sheraton hotels allegedly rigged the bidding for produce products by providing one supplier with competitive bid information. With this information, the supplier obtained a number of contracts by placing the lowest bid. In exchange, the buyers allegedly received hundreds of thousands of dollars in kickback payments, received monthly from the supplier in the form of cash slid under the door of the buyers' offices.

The "off the books" nature of kickbacks makes them particularly difficult for auditors to detect. In this case, the two buyers were arrested as a part of a federal investigation of corruption at city produce markets. Factors that might indicate the existence of kickbacks include

- A purchasing employee who appears to be living beyond their means.
- An improper or questionable basis for selecting suppliers.
- Selection of a supplier with high prices, or prices that have increased significantly since the supplier was first selected.
- Purchasing records that indicate that one company consistently "wins contracts" as the lowest bidder, often by a relatively small amount.
- Continued purchases from a supplier providing products of questionable quality.
- Tips from other employees.

Control Environment

As described in Chapter 7, the control environment reflects the overall attitude, awareness, and actions of management and the board of directors concerning the importance of control and the way it is used in the entity. The aspects of the control environment that are particularly relevant to the auditors' consideration of the inventories and cost of goods sold include

1. **Commitment to attract, develop, and retain competent employees.** These policies and practices help ensure that appropriately qualified and trained personnel are assigned the responsibilities for purchasing goods and services, receiving and storing the goods, and making estimates of inventory values. A *commitment to competence* with respect to plant personnel is important to ensuring that the manufacturing process is efficient and effective and that prescribed control activities are being performed.
2. **Integrity and ethical values.** Purchasing and cash disbursement activities provide ample opportunity for fraud by employees, as well as by management. Communication of management's integrity and ethical values helps ensure that disbursements are for authorized and legitimate goods that were actually received and that the accounting for the purchases is appropriate. The importance of competence and integrity may be illustrated by considering the company's purchasing agents who negotiate the terms of purchases with the company's various suppliers. If these individuals are incompetent, they may commit the company to large purchases at unfavorable terms. If purchasing agents accept "kickbacks," the company not only will lose the amounts accepted, but may make purchases of substandard goods or pay excessive prices. Communication of integrity and ethical values also helps ensure that estimates related to inventories are reliable.
3. **Organizational structure and assignment of authority and responsibility.** Internal control is improved when the client's organizational structure is appropriate and when levels of authority and responsibility for purchasing and production activities are clearly communicated. It is especially important for personnel involved in purchasing, receiving, and production to understand their responsibilities for the application of controls.

Risk Assessment

The risk of material misstatement of inventories and cost of goods sold is reduced when management evaluates and manages the risks related to purchasing and producing goods and services. Aspects of concern to the auditors include management's assessment of risks related to (1) the availability of a supply of goods, services, and skilled labor; (2) the stability of prices and labor rates; (3) the generation of sufficient cash flow to pay for purchases; (4) changes in technology that affect manufacturing processes; and (5) the obsolescence of inventory.

Monitoring

Relevant monitoring controls for the purchases cycle include management review of reports of purchases from suppliers, inventory on hand, and accounts payable balances. Management may establish a process of obtaining feedback from suppliers, including complaints about delays in payments. **Management review controls** for the production cycle include observations by production supervisors of the performance of various activities and quality and performance reviews. Inventory and production schedules should be reviewed by management; any unusual items and relationships should be investigated and resolved. While these controls may be implemented manually, data analytics software can be used to monitor transactions and other activities on a continuous basis. The software also may be used to review inventory costs and entries to inventory accounts to identify unusual entries and relationships.

Purchases and Production Cycles—Accounting Systems and Control Activities

LO 12-3

Describe the documents, records, and accounts that are involved in the purchases and production (conversion) cycles and the fundamental controls over inventories, purchasing, and production.

Purchasing, receiving, storing, issuing, processing, and shipping are the physical functions directly connected with inventories; the cost accounting system and the perpetual inventory records compose the recording functions. Because the auditors are interested in the final products of the recording functions, it is necessary for them to understand and evaluate the cost accounting system and the perpetual inventory records, as well as the various control activities and original documents underlying the preparation of financial data.

The Purchasing Function

Strong internal control over purchases ordinarily involves an organizational structure that delegates to a separate department of the company exclusive authority to make all purchases of materials and services. The purchasing, receiving, and recording functions should be clearly separated and lodged in separate departments. In small companies, this type of departmentalized operation may not be possible, but even in very small enterprises, it is usually feasible to make one properly supervised person responsible for all purchase transactions.

A purchase transaction begins with the issuance of a properly approved electronic or paper *purchase requisition* (below) by the stores department or another department needing the goods or services. A copy of the requisition is sent to the purchasing department to provide a basis for preparing the serially numbered *purchase order* (below). The requisition should include a precise description of the type and quantity of the goods or services desired.

67467500	
Perfect Manufacturing Co. <u>Purchase Requisition</u>	
Department: <u>Raw Materials Stores</u>	Date: <u>May 10, 20X1</u> Date Required: <u>June 5, 20X1</u>
Quantity 9,000 sheets	Description 2×8, 1/2" steel sheets #278473
Approved By: <u>Casey Rowe</u>	

AA09847			
PURCHASE ORDER Perfect Manufacturing Co. 1212 Belaire Blvd. Houston, TX 77062			
To: <u>Carson Steel Co.</u>		Date: <u>May 12, 20X1</u>	
<u>1671 21st St.</u>			
<u>Houston, TX 77021</u>		Ship via: <u>SOS Delivery</u>	
Terms: <u>2/10, n/30</u>			
Enter our order for:			
Qty.	Description	Price	Total
9,000 sheets	2×8, 1/2" steel #278473	\$21.00	\$189,000
Perfect Manufacturing Co. By: <u>Linda Jones</u>			

Copies of the purchase order should be forwarded to the accounting and receiving departments. The copy sent to receiving should have the quantities omitted to increase the likelihood that receiving personnel will make independent counts of the merchandise received. Even though the buyer may actually place an order by telephone, the formal purchase order should be prepared and forwarded. In many large organizations, purchase orders are issued only after compliance with extensive procedures for (1) determining the need for the item, (2) obtaining competitive bids, and (3) obtaining approval of the financial aspect of the commitment.

The Receiving Function

All goods received by the company—without exception—should be cleared through a receiving department that is independent of the purchasing, storing, and shipping departments. The receiving department is responsible for (1) the determination of quantities of goods received, (2) the detection of damaged or defective merchandise, (3) the preparation of a *receiving report* (below), and (4) the prompt transmittal of goods received to the stores department.

The Storing Function

As goods are delivered to stores, they are counted, inspected, and receipted for. The stores department then notifies the accounting department of the amount received and placed in stock. In performing these functions, the stores department makes an important contribution to overall control of inventories. By signing for the goods, it fixes its own responsibility and, by notifying the accounting department of actual goods stored, it provides verification of the receiving department's work.

The Issuing Function

The stores department, being responsible for all goods under its control, has reason to insist that a requisition (below) be issued for all items passing out of its hands to serve as a signed receipt from the department accepting the goods. To prevent the indiscriminate writing of requisitions for questionable purposes, some organizations establish policies requiring that requisitions be drawn only upon the authority of a bill of materials, an engineering order, or a sales order. In wholesale and retail concerns, shipping orders, rather than factory requisitions, serve to authorize withdrawals from stores.

5874983	
Perfect Manufacturing Co. <i>Receiving Report</i>	
Received From: <u>Carson Steel Co.</u> <u>1671 21st St.</u> <u>Houston, TX 77021</u>	Date: <u>June 5, 20X1</u> Order No: <u>AA09847</u> Carrier: <u>SOS Delivery</u>
Quantity 9,000 sheets	Description 2x8, 1/2" steel #278473
Received By: <u>Don Warren</u>	

4503945			
Perfect Manufacturing Co. <i>Materials Requisition</i>			
<i>Production Order: 8576409</i>			
Department: <u>Milling #23</u>		Date: <u>June 10, 20X1</u> Date Required: <u>June 10, 20X1</u>	
Quantity 350 sheets	Description 2x8, 1/2" steel	Unit Cost \$32.40	Total Cost \$11,340.00
Approved By: <u>John West</u>			

The Production (Conversion) Function

Overall production should be controlled with a **master production schedule** that presents the gross production needs for a particular period. Because the schedule is developed based on forecasts of demand for the company's products, it helps to ensure that the company will meet its customers' needs, while not overstocking particular products. The master production schedule also ensures that materials and labor are available, on a timely basis, to meet the production demands for the period. Once the required resources are determined to be available, **production orders** are prepared to authorize the production of specific products.

Responsibility for the goods in production must be fixed, usually on factory supervisors or superintendents. *Materials requisitions* and *move tickets* document the flow of the goods and related responsibility as they progress through the production process. Thus, from the time materials are delivered to the factory until they are completed and routed to a finished goods storeroom, a designated supervisor should be in control and be prepared to answer for their location and disposition.

Job time tickets (below) are prepared to document the labor or machine-hours devoted to a particular production job. Each job time ticket should be reviewed and approved by the department supervisor before it is entered into the cost accounting system.

The controls for goods in production usually include regular inspection procedures to reveal defective work. This aids in disclosing inefficiencies in the productive system and also tends to prevent inflation of the goods in process inventory by the accumulation of cost of goods that will eventually be scrapped. If scrapped materials have substantial salvage value, the materials should be segregated, controlled, and inventoried.

The Shipping Function

Shipments of goods should be made only after proper authorization has been received. This authorization will normally be a sales order approved by the credit department, although the shipping function also includes the returning of defective goods to suppliers. In this latter case, the authorization may take the form of a shipping authorization from a purchasing department executive.

The shipping department will prepare, or the computer system will generate, a pre-numbered *shipping document* (below) indicating the goods shipped. One copy of the shipping document should be retained by the shipping department as evidence of shipment; a second copy should be sent to the billing department, where it will be used—with

Perfect Manufacturing Co. Job Time Ticket Production Order: 8576409			
Date: <u>06/18/X1</u> Dept. No. <u>23</u> Dept. Milling			
Employee No. 2954	Name Larry Cobb	Hourly Rate \$22.50	Operation Cut to shape
Start Time 6:00 A.M.	End Time 11:30 A.M.	Total Hours 5.5	Total Labor Dollars \$123.75
Quantity Completed: 350 Valve Bases			
Approved By: <u>Chee Chow</u>			

SHIPPING DOCUMENT Perfect Manufacturing Co. 1212 Belaire Blvd. Houston, TX 77062			54654566
Consigned to: <u>Flour Valve Co.</u> <u>5485 First St.</u> <u>Kansas City, MO 66220</u>		Date: <u>Oct. 21, 20X1</u> Order No. 6779938	
Shipper: <u>Union Pacific</u>			
Quantity 150	Description 9' Outflow valves #2988388	Weight 7845	
Packed by: <u>Leon Jones</u>		Received by: <u>John Carr</u>	

the customer's purchase order and the sales order—as the basis for invoicing the customer; and a third copy should be enclosed as a packing slip with the goods when they are shipped. The control aspect of this procedure is strengthened by the fact that an outsider, the customer, will generally inspect the packing slip and notify the company of any discrepancy between this list, the goods ordered, and the goods actually received.

When the goods are shipped using a common carrier, a fourth copy of the shipping document, required in this case to be a **bill of lading**, is provided to the carrier. In addition, the copy forwarded to billing will include additional evidence of shipment in the form of trucking bills, carriers' receipts, or freight bills. Subsequent audit of the transactions is facilitated by grouping together the documents showing that shipments were properly authorized and carried out.

Established shipping routines should be followed for all types of shipments, including the sale of scrap, return of defective goods, and forwarding of materials and parts to subcontractors.

The Cost Accounting System

An adequate cost accounting system is necessary to account for the usage of raw materials and supplies, to determine the content and value of goods in process inventories, and to compute the finished goods inventory. This system comprises all the records, orders, and requisitions needed for proper accounting for the disposition of materials as they enter the flow of production and as they continue through the factory in the process of becoming finished goods. The cost accounting system also serves to accumulate labor costs and indirect costs that contribute to the goods in process and the finished goods inventories. The cost accounting system thus forms an integral part of the internal control over inventories.

The figures produced by the cost accounting system should be controlled by general ledger accounts. The costs of direct materials and labor are recorded in individual goods (work) in process accounts for each job order or process. Periodically, manufacturing overhead is applied to the jobs or processes and recorded in the accounts.

Underlying this upper level of control between the factory records and the general ledger is a system of production orders, material requisitions, job tickets or other labor distributions, and factory overhead distributions. Control is affected by various procedures that verify the accuracy of production records. Allocations of direct materials and labor costs are recomputed and reconciled to material and payroll records. Manufacturing overhead costs that are applied using predetermined rates are adjusted to actual costs at the end of the period.

Many companies have established standard cost systems that help identify the causes of ineffectiveness and waste through a study of variances between actual and standard costs. These systems provide for the prompt pricing of inventories and for control over operations. All the various types of cost accounting systems are alike in that they are designed to contribute to effective internal control by tracing the execution of managerial directives in the factory, providing reliable inventory figures, and safeguarding company assets.

The Perpetual Inventory System

Perpetual inventory records constitute an extremely important part of internal control. These records, by showing at all times the quantity of goods on hand, provide information essential to intelligent purchasing, sales, and production-planning policies. With such a record, it is possible to guide procurement by establishing points of minimum and maximum quantities for each standard item stocked.

The use of a perpetual inventory system allows companies to control the high costs of holding excessive inventory, while minimizing the risk of running out of stock. The company can control inventories through reorder points and economic order quantities, including *just-in-time* ordering systems in which inventory levels are kept to a minimum.

If perpetual inventory records are to produce the control implicit in their nature, it is desirable that the subsidiary records be maintained in both quantities and dollars for all stock, that the subsidiary records be controlled by the general ledger, and that trial balances be prepared at reasonable intervals. In addition, both the detailed records and the



Illustrative Case

Drones for Inventory Management

Some companies that have a large number of inventory items, especially those with items that are hard to access, use drone technology, coupled with RFID and barcoding sensor capabilities, to perform cycle counts of their inventories.

The drones can be programmed to perform automatic inventory checks throughout a warehouse, including in hard-to-access areas. Such technology can improve the effectiveness and efficiency of inventory management and control.

general ledger control accounts should be adjusted to agree with physical counts whenever they are taken.

Perpetual inventory records discourage inventory theft and waste because storekeepers and other employees are aware of the accountability over goods established by this continuous record of goods received, issued, and on hand. The records, however, must be periodically verified through the physical counting of goods.

IT Systems

An IT-based inventory system makes it much easier for the client to maintain control over inventories, purchasing, and the manufacturing process. The IT system can automatically generate purchase requisitions and orders when inventory levels reach predetermined reorder points. The client's purchasing system may even be linked to the system of its suppliers, allowing **electronic data interchange (EDI)** to completely coordinate production and purchasing. The IT system also maintains records of responsibility for goods as they are routed through the production process. Details of direct labor and materials usage are entered, and the computer then allocates these direct costs to jobs or processes, applies manufacturing overhead costs based on predetermined rates, and maintains perpetual records of the costs of goods in process, finished, and sold. The system also generates various financial reports, including *responsibility accounting reports* that indicate actual costs, standard costs, and the related variances.

The use of IT also can improve inventory tracking. As an example, many companies use bar code technology, in which all products or containers of products are tagged with a bar code that can be scanned when the item is shipped or when an inventory is taken. Other companies use radio frequency identification (RFID) to track inventory. In these systems, products or containers of products are tagged with microchips that can be read remotely without line-of-sight. RFID readers at warehouse entrances can keep track of inventory on a real-time basis. IT-enabled inventory-tracking systems reduce the errors in inventory handling and shipping and facilitate inventory control and inventory taking.

Good internal control in IT systems requires the normal segregation of the purchasing, receiving, storing, processing, and shipping functions. In addition, the client should establish appropriate IT controls that promote the accuracy of data as they are entered into the system and ensure that data maintain their integrity after they are entered.

Controls over Inventory Estimates

Certain companies, such as large retail companies, may develop estimates of certain inventory quantities on hand. In addition, most firms selling products must develop estimates related to inventory items that have declined in value, including obsolete products. These companies should establish controls over the development of the estimates, including:

- Involving competent and informed personnel in developing the estimates.
- Establishing controls over the relevance, completeness, and reliability of data used to make the estimates, and the accuracy of computations.
- Requiring management review and approval of the estimates.

Audit Documentation for Inventories and Cost of Goods Sold

The auditors may prepare a great variety of working papers in their verification of inventories and cost of goods sold. These papers will range in form from written comments on the manner in which the physical inventory was taken to elaborate analyses of production costs of finished goods and goods in process. Selected working papers will be illustrated in connection with the audit procedures to be described in later sections of this chapter.

Audit of Inventories and Cost of Goods Sold

The following steps indicate the general pattern of work performed by the auditors in the verification of inventories and costs of goods sold. Selection of the most appropriate procedures for a particular audit will be guided by the nature of the internal controls that have been implemented and by the results of the auditors' risk assessments.

- A. Use the understanding of the client and its environment to consider inherent risks, including fraud risks, related to inventories and cost of goods sold.
- B. Obtain an understanding of internal control over inventories and cost of goods sold.
- C. Assess the risks of material misstatement and design further audit procedures.
- D. Perform further audit procedures—tests of controls.
 1. Examples of tests of controls:
 - a. Test controls over purchase transactions.
 - b. Test controls over the cost accounting system.
 - c. Test management review controls.
 - d. Test controls over inventory estimates.
 2. If necessary, revise the risks of material misstatement based on the results of tests of controls.
- E. Perform further audit procedures—substantive procedures for inventories and cost of goods sold.
 1. Obtain listings of inventory and reconcile to ledgers.
 2. Evaluate the client's planning of physical inventory.
 3. Observe the taking of physical inventory and make test counts.
 4. Review the year-end cutoff of purchases and sales transactions.
 5. Obtain a copy of the completed physical inventory, test its clerical accuracy, and trace test counts.
 6. Evaluate the bases and methods of inventory pricing.
 7. Test the pricing of inventories.
 8. Perform analytical procedures or data analytics.
 9. Determine whether any inventories have been pledged and review purchase and sales commitments.
 10. Evaluate financial statement presentation of inventories and cost of goods sold, including the adequacy of disclosure.

Figure 12.1 relates the objectives of the major substantive procedures for inventories and cost of goods sold to the primary audit objectives.

LO 12-4

Use the understanding of the client and its environment to consider inherent risks (including fraud risks) related to inventories, purchases, and cost of goods sold.

A. Use the Understanding of the Client and Its Environment to Consider Inherent Risks, Including Fraud Risks, Related to Inventories and Cost of Goods Sold.

Generally, inventories represent an asset with significant inherent risks. Some of these risks arise from business risks faced by management, such as the risk of losses due to poor product quality, obsolescence, or theft. Other factors that affect the risks of material misstatement of inventories include

1. Inventories often constitute a large current asset of an enterprise and are very susceptible to major errors and fraud.
2. The accounting profession allows numerous alternative methods for valuation of inventories, and different methods may be used for various classes of inventories.

FIGURE 12.1
Objectives of Major
Substantive Procedures
for Inventories and Cost
of Goods Sold

Substantive Procedures	Primary Audit Objectives
Obtain listings of inventory and reconcile to ledgers.	<i>Existence, occurrence, and rights</i>
Evaluate the client's planning of physical inventory.	<i>Existence, occurrence, and rights</i>
Observe the taking of the physical inventory.	<i>Completeness</i>
Review the year-end cutoff of purchase and sales transactions.	<i>Valuation</i>
Obtain a copy of the completed physical inventory and test its accuracy.	<i>Cutoff</i>
Evaluate the bases and methods of inventory pricing.	<i>Valuation</i>
Test the pricing of inventories.	<i>Valuation</i> <i>Accuracy</i>
Perform analytical procedures or data analytics.	<i>Existence and rights</i> <i>Completeness</i> <i>Valuation</i> <i>Accuracy</i>
Determine whether any inventories have been pledged and review commitments.	<i>Valuation</i> <i>Presentation and disclosure</i>
Evaluate financial statement presentation and disclosure.	<i>Presentation and disclosure</i>



3. The determination of inventory value directly affects the cost of goods sold and has a major impact on net income for the year. Therefore, if management is inclined to engage in fraudulent financial reporting, the fraud will likely involve overstatement of inventory.
4. The determination of inventory quality, condition, and value is inherently a more complex and difficult task than is the case with most other elements of financial position. Many items, such as precious gems, sophisticated electronic parts, and construction in progress, present significant problems of identification and valuation.

If auditors identify a fraud risk with respect to inventories, they will make sure that they understand the programs and controls established by management to control the risk. They also will determine that the controls have been implemented. Finally, the auditors will design appropriate procedures to respond to that risk.

B. Obtain an Understanding of Internal Control over Inventories and Cost of Goods Sold.

LO 12-5

Obtain an understanding of internal control over inventories and cost of goods sold.

As previously indicated, the consideration of controls may involve the filling out of a questionnaire, the writing of descriptive memoranda, or the preparation of flowcharts depicting the organizational structure and the flow of materials and documents. In obtaining an understanding of internal control over inventory, the auditors should become thoroughly familiar with the procedures for purchasing, receiving, storing, and issuing goods and for controlling production, and they should obtain an understanding of the cost accounting system and the perpetual inventory records.

The auditors also should give consideration to the physical protection of inventories. Any deficiencies in storage facilities, in guard service, or in physical handling that may lead to losses from weather, fire, flood, or theft may appropriately be called to the attention of management.

The matters to be investigated in the auditors' consideration of controls over inventory and cost of sales are fairly well indicated by the following questions: Are perpetual inventory records maintained for each class of inventory? Are perpetual inventory records verified by physical inventories at least once each year? Do the procedures for physical inventories include the use of prenumbered tags, with all tag numbers accounted for? Are differences between physical inventory counts and perpetual inventory records investigated before the perpetual records are adjusted? Is a separate purchasing department responsible for purchasing all materials, supplies, and equipment? Does a separate receiving department

process all incoming shipments? Are materials and supplies held in the custody of a stores department and issued only upon receipt of properly approved requisitions?

After the auditors have prepared a flowchart (or other description) of internal control, they should determine that the client is using those procedures; that is, they should determine whether the controls have been *implemented*. This information may be obtained through inquiries of entity personnel, inspection of documents, and observation of activities, which are often performed in conjunction with a walk-through of the accounting cycle. As the auditors obtain their understanding of the controls, they will observe whether there is an appropriate segregation of duties and inquire as to who performed various functions throughout the year. They also will inspect various documents, such as purchase requisitions, purchase orders, material requisitions, move tickets, time tickets, and shipping advices, and review document files to determine that the client is appropriately accounting for the sequence of prenumbered documents. Inventory, production, and responsibility accounting reports will be examined, and the auditors will review the evidence of follow-up on variances from standard costs.

Focus on the Agribusiness Industry

Accounting for the inventory of an agricultural producer provides a good example of the need for industry expertise when obtaining an understanding of a client's internal control over inventory. Auditors of agricultural producers that are involved in raising animals must pay special attention to the effectiveness of the agricultural producer's internal control, including whether

- The controls provide accurate quantity and cost data for the raised animals.
- The payroll records are sophisticated enough to allow labor cost to be allocated to the appropriate animal component of inventory.
- Direct and indirect costs of developing animals raised for a productive function are accurately accumulated until the animals reach maturity, at which point the costs are depreciated over the animals' estimated productive life.
- Direct and indirect costs of developing animals raised for sale are accumulated to ensure the accuracy of inventory and the cost of animals sold.

LO 12-6

Assess the risks of material misstatement of inventories and cost of goods sold and design further audit procedures, including tests of controls and substantive procedures, to address the risks.

C. Assess the Risks of Material Misstatement and Design Further Audit Procedures.

After considering the information about the client and its environment, including internal control over inventories and cost of goods sold, the auditors identify and assess the risks of material misstatement at the financial statement and assertion levels. To make these assessments, the auditors should consider the relationships between specific misstatements and controls. Figure 12.2 provides examples of potential misstatements of inventories and cost of goods sold and weaknesses in internal control that would make them more likely to occur. You should also refer back to Figure 11.4, which includes a number of misstatements of revenue that also may involve misstatements of inventory.

The auditors' assessments of the risks of material misstatement are used to design further audit procedures, including tests of controls and substantive procedures. Tests of controls are designed when the auditors' assessments of control risk assume that controls are operating effectively but, in regard to their understanding of the client's internal control, the auditors have not obtained sufficient evidence through tests of controls already performed.

Some of the risks identified by the auditors may be considered to be significant risks that require special audit consideration. As an example, a client may have inventories that have a very high risk of obsolescence. This significant risk may require the auditors to perform more procedures focused on identifying inventories that are overvalued, such as the performance of detailed analytical procedures. Recall that for a significant risk the auditors

1. Evaluate the design of the related controls and determine that they are implemented.
2. Perform substantive procedures.

FIGURE 12.2 Potential Misstatements—Inventory

Description of Misstatement	Examples	Internal Control Weaknesses or Factors That Increase the Risk of the Misstatement
Misstatement of inventory costs	Fraud: - Intentional misstatement of production costs assigned to inventory - Intentional misstatement of inventory prices	Ineffective board of directors, audit committee, or internal audit function; “tone at the top” not conducive to ethical conduct; undue pressure to meet earnings targets
	Errors: - The assignment of direct labor costs, direct material costs, or factory overhead to inventory items is inaccurate - Erroneous pricing of inventory	- Ineffective cost accounting system; failure to update standard costs on a timely basis - Ineffective input validation controls on the database of inventory costs; ineffective supervision of the personnel who enter the costs on the final inventory schedule
Misstatement of inventory quantities	Fraud: - Items are stolen with no journal entry reflecting the theft - Inventory quantities in locations not visited by auditors are systematically overstated	- Ineffective physical controls over inventories - Ineffective board of directors, audit committee, or internal audit function; “tone at the top” not conducive to ethical conduct; undue pressure to meet earnings targets
	Error: Miscounting of inventory by personnel involved in physical inventory	Ineffective controls or supervision of physical inventory
Early (late) recognition of purchases—“cutoff problems”	Fraud: Intentional recording of purchases in the subsequent period	Ineffective board of directors, audit committee, or internal audit function; “tone at the top” not conducive to ethical conduct; undue pressure to meet earnings targets
	Error: Recording purchases of the current period in the subsequent period	Ineffective accounting procedures that do not tie recorded purchases to receiving data

*See also Figure 11.4, Potential Misstatements—Revenue, because many types of revenue misstatements involve misstatement of inventory.

- Test the operating effectiveness of the related controls in the current period when they plan to rely on those controls.

D. Perform Further Audit Procedures—Tests of Controls.

Tests directed toward the effectiveness of controls help to evaluate the client’s internal control and determine whether the auditors can support their planned assessed levels of control risk for the assertions about the inventory and cost of goods sold accounts. Certain tests of controls are performed as the auditors obtain an understanding of the client’s internal control; these tests were described in our discussion of that process.

1. Examples of Tests of Controls.

a. Test controls over purchase transactions.

The accurate recording of purchase transactions is essential to reliable accounting records. The auditors likely performed many tests of these records in conjunction with the audit of cash disbursement. Tests of the purchases cycle may include the following steps:

- Select a sample of purchase transactions.
- Examine the purchase requisition or other authorization for each purchase transaction in the sample.

3. Examine the related vendor's invoice, receiving report, and paid check for each purchase order in the sample. Trace transactions to the voucher register and check register.
4. Inspect vendors' invoices for approval of prices, freight and credit terms, and account distribution, and recompute extensions and footings.
5. Compare quantities and prices in the invoice, purchase order, and receiving report.
6. Trace postings from voucher register to general ledger and any applicable subsidiary ledgers.

While these steps may be performed manually, most may be performed more efficiently for all of the transactions with the use of data analytics software. Data analytic techniques will allow the auditors to test 100 percent of the transactions for authorization, approval, and receipt of the goods. Simultaneously, the purchase transactions may be tested for misstatement.

b. Test controls over the cost accounting system.

For a client in the manufacturing field, the auditors should become familiar with the client's cost accounting system. A wide variety of practices will be encountered for the costing of finished units. The cost accounting records may be controlled by general ledger accounts or operated independently of the general accounting system. In the latter case, the cost of completed units may be difficult or impossible to verify and may represent nothing more than a well-reasoned guess. Because cost accounting methods vary so widely, even among manufacturing concerns in the same industry, audit procedures for a cost accounting system must be designed to fit the specific circumstances encountered in each case.

In any cost accounting system, the three elements of manufacturing cost are direct materials costs, direct labor costs, and manufacturing overhead. Cost accounting systems may accumulate either actual costs or standard costs according to *processes* or *jobs*. The auditors' tests of the client's cost accounting system are designed to determine that costs allocated to specific jobs or processes are accurate and complete.

To achieve this objective, the auditors test the propriety of direct materials quantities and unit costs, direct labor-hours and hourly rates, and overhead rates and allocation bases. Quantities of direct materials charged to jobs or processes are vouched to materials requisitions, and unit materials costs are traced to the raw materials perpetual inventory records or purchase invoices. The auditors examine job time tickets or time summaries supporting direct labor-hour accumulations and trace direct labor hourly rates to union contracts or individual employee personnel files. When the client has a well-controlled IT system, the auditors can perform most of these procedures on 100 percent of the transactions, records, or items using data analytics software.

The auditors should recognize that a variety of methods are generally accepted for the application of manufacturing overhead to inventories. A predetermined rate of factory overhead applied on the basis of machine-hours, direct labor dollars, direct labor-hours, or some similar basis is used by many manufacturing companies. Accounting standards provide that variable manufacturing costs should be allocated to products on the basis of the actual level of activity. Fixed manufacturing overhead, on the other hand, should be allocated based on the normal capacity of the production facility.

A distinction between factory overhead, on the one hand, and costs pertaining to selling or general administration of the business, on the other, must be made under generally accepted accounting principles because selling expenses and general and administrative expenses are expensed in the period incurred. The difference in the accounting treatment accorded to factory overhead and to nonmanufacturing costs implies a fundamental difference between these two types of cost. Nevertheless, as a practical matter, it is often impossible to say with finality what proportion of a particular expenditure, such as the salary of a vice president in charge of production, should be classified as factory overhead and as general and administrative expense. Despite this difficulty, a vital procedure in the audit of cost of goods sold for a manufacturing concern is determining that factory

overhead costs are reasonably allocated. Failure to distribute factory costs to the correct accounts can cause significant distortions in the client's predetermined overhead rate and in over- or underapplied factory overhead. The auditors may find it necessary to obtain or prepare analyses of a number of the factory overhead subsidiary ledger accounts and to verify the propriety of the charges thereto. Then, the auditors should determine the propriety of the total machine-hours, direct labor-hours, or other aggregate allocation base used by the client company to predetermine the factory overhead rate.

If standard costs are in use, it is desirable to compare them with actual costs for representative items and to determine whether the standards reflect current materials and labor usage and unit costs. The composition of factory overhead, the basis for its distribution by department and product, and the effect of any change in basis during the year should be reviewed. The standard costs of selected products should be verified by testing computations, extensions, and footings and by tracing charges for labor, materials, and overhead to original sources. Normal variances between standard costs and actual costs are allocated to cost of goods and inventories on a pro rata basis.

The auditors' study of a manufacturing company's cost accounting system should give special attention to any changes in cost methods made during the year and the effect of such changes on the cost of sales. Close attention also should be given to the methods of summarizing costs of completed products and to the procedures for recording the cost of partial shipments.

If the client company has supply contracts with U.S. government agencies, the auditors should determine whether standards issued by the **Cost Accounting Standards Board** were complied with. Cost accounting standards issued to date have dealt with such matters as consistency in estimating, accumulating, allocating, and reporting costs and depreciation of plant assets.

c. Test management review controls.

Management review controls may be effective at detecting and correcting misstatements that are not detected by other controls. The auditors will evaluate these controls by considering the relevance of the assertions addressed by the controls, the level of aggregation of the data, how often it is performed, the predictability of management expectations, and the criteria used to determine when items are investigated. If the design of the controls is considered to be effective, the auditors may test the controls by inspecting production and inventory schedules and other documentation of performance of the controls, including documentation of the manner in which unusual items or relationships were identified, investigated, and resolved.

d. Test controls over inventory estimates.

In many situations, significant estimates must be used to value inventories. As an example, estimates may be necessary to determine the net realizable value of obsolete inventory. The auditors may evaluate and test controls over the client's development of the estimates, including review and testing of the data used, computations, and the assumptions made. The auditors should also evaluate the competence of the personnel involved in making the estimates.

2. If Necessary, Revise the Risks of Material Misstatement Based on the Results of Tests of Controls.

The description and tests of controls of the client's internal control over inventories and cost of goods sold provide the auditors with evidence as to weaknesses and strengths of the system. If the tests of controls reveal problems, the auditors should reassess the risks of material misstatement for the financial statement assertions about inventories and cost of goods sold. Figure 12.3 illustrates the relationship between the assertions and the various controls. It also shows how these policies and procedures are typically tested. The auditors' assessments of the risks of material misstatement are then used to design the substantive tests for these accounts.

FIGURE 12.3 Relating Controls to Assertions

Internal Control Policy or Procedure	Typical Tests of the Control Policy or Procedure	Existence & Occurrence	Completeness	Cutoff	Rights & Obligations	Valuation & Accuracy	Presentation & Disclosure
Segregate duties over purchases and custody of inventories.	Observe and make inquiries about the performance of various functions.	X	X		X	X	
Use prenumbered requisitions, purchase orders, and receiving reports and account for the sequence of documents.	Observe and make inquiries about the use of prenumbered documents and inspect evidence of accounting for the sequence.		X	X			
Establish procedures for authorizing purchase transactions, reconciling purchase invoices to purchase orders and receiving reports, and verifying the clerical accuracy of purchase invoices.	Observe and make inquiries about purchase procedures, and test a sample of purchase transactions by inspecting evidence of authorizations and reconciliations, comparing the details to authorized purchase orders and receiving reports, and recomputing the invoice amounts.	X			X	X	
Establish general ledger control of inventories of raw materials, goods in process, and finished goods, and periodically reconcile to production records.	Inspect accounting and production records and selected reconciliations.	X			X	X	X
Establish controls for the cost accounting system that accumulate appropriate inventory costs on a job order or process cost basis, such as independent review of cost accumulations.	Inspect evidence of independent reviews of cost accumulations, recompute materials costs by reference to requisitions and purchase invoices, and recompute direct labor costs by reference to time and payroll records and overhead application rates.					X	
Analyze and follow up on variances from standard costs.	Inspect inventory reports and examine evidence of follow-up on variances.	X	X			X	
Use perpetual records to control inventories.	Inquire about the perpetual inventory procedures, and test the records by reference to purchase invoices, receiving reports, and production records.	X	X	X		X	X
Use appropriate procedures for taking the physical inventory.	Review the inventory instructions and observe the inventory-taking process.	X	X	X	X	X	
Establish appropriate physical controls over inventories	Observe and inquire about the physical control policies and procedures.	X			X		
Establish appropriate controls over inventory estimates.	Inquire and test the qualifications of personnel involved in developing the estimates; test controls over the procedures used to develop estimates, including controls over data and assumptions.						

E. Perform Further Audit Procedures—Substantive Procedures for Inventories and Cost of Goods Sold.

1. Obtain Listings of Inventory and Reconcile to Ledgers.

The auditor will obtain a schedule of listings of inventories that will be reconciled to both the general ledger and appropriate subsidiary ledgers. The nature of the listings will vary depending upon whether the client engages in manufacturing or simply sells products at retail. The auditors' goal in performing this step is to make sure the inventory records agree with what is recorded in the financial statements.

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Rights	☒

2. Evaluate the Client's Planning of Physical Inventory.

Efficient and effective inventory taking requires careful advance planning. Cooperation between the auditors and client personnel in formulating the procedures to be followed will prevent unnecessary confusion and will aid in securing a complete and well-controlled count. A first step is the designation by the client management of an individual employee, often a representative of the controller, to assume responsibility for the physical inventory. This responsibility will begin with the drafting of procedures and will carry through to the final determination of the dollar value of all inventories.

In planning the physical inventory, the client should consider many factors, such as (a) selecting the best date or dates, (b) suspending production in certain departments of the plant, (c) segregating obsolete and defective goods, (d) establishing control over the counting process through the use of inventory tags or sheets, (e) achieving proper cutoff of sales and purchase transactions, and (f) arranging for the services of engineers or other specialists to determine the quantity or quality of certain goods or materials.

Once the plan has been developed, it should be documented and communicated in the form of written instructions to the personnel taking the physical inventory. These instructions normally will be drafted by the client and reviewed by the auditors, who will judge their adequacy. A set of instructions prepared by the controller of a large clothing store for use by supervisors is shown in Figure 12.4. In evaluating the adequacy of the instructions, the auditors should consider the nature and materiality of the inventories, as well as the existing internal control. Normally, the auditors will insist that the inventory be taken at or near the balance sheet date. However, if the client has effective internal control, including perpetual records, the auditors may be satisfied to observe inventory counts performed during the year, and no audit report modification is necessary. If the client plans to use a statistical sampling technique to estimate the quantities of inventories, the auditors will evaluate the statistical validity of the sampling method and the propriety of the sampling risk and the allowance for sampling risk.

Advance planning by the senior auditor-in-charge is also necessary to ensure efficient use of audit staff members during the inventory taking. The auditor-in-charge should determine the dates of the counts, the extent of the test counts, the need for client assistance, the number of auditors needed at each location, and the estimated time required. When multiple locations are involved, the auditors should determine whether the assessed levels of the risks of material misstatement justify omission of observation at certain locations. When only certain locations are to be observed, the auditors should consider not informing the client of the specific locations in advance. In addition, the observation should be planned in a manner that ensures that client employees are not aware of the exact nature of all items that are test-counted by the auditors.

Advance planning also may reveal to the auditors a need to rely upon the advice of a **specialist** for discharging their responsibility for testing inventory. For example, the auditors of a retail jeweler might engage an independent expert in gems to assist in identifying the precious stones and metals included in the client's inventory. Similarly, the auditors of a chemical producer might rely upon the expert opinion of an independent chemist as to the identity of components of the client's inventories. Guidelines for using the work of a specialist were presented in Chapter 5.

When written instructions are prepared by the auditing firm for the use of its staff in a particular engagement, these instructions are not made available to the client. Their purpose

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Completeness	☒
Rights	☒
Valuation	☒
Cutoff	☒



Illustrative Case

Fraud at Phar-Mor

A number of years ago, it was reported that audits of Phar-Mor Inc., a discount drugstore chain, did not detect a \$50 million overstatement of inventory. The allegedly fraudulent overstatements occurred at stores at which the client knew in advance that the CPAs did not intend to observe inventory counts. The client refrained from making

fraudulent adjustments at the stores where it knew that the CPAs would observe the inventories. In another case, auditors are reported to have permitted company officials to follow them and record where test counts of inventory were taken; the managers subsequently falsified counts for inventory items that weren't test-counted by the auditors.

FIGURE 12.4
Instructions for Physical Inventory

GLEN HAVEN DEPARTMENT STORES, INC.

Instructions for Physical Inventory,
August 5, 20X0

TO ALL SUPERVISORS:

A complete physical inventory of all departments in each store will be taken Sunday, August 5, 20X0, beginning at 8:30 a.m. and continuing until completed. Employees are to report at 8:15 a.m. to receive their final briefing on their instructions, which are appended hereto.

Within one week prior to August 5, supervisors should make sure that merchandise in departments is well organized. All merchandise with the same stock number should be located together. Merchandise that is damaged should be segregated for separate listing on inventory sheets.

Each count team should be formed and started by a supervisor and should be periodically observed by that supervisor to assure that instructions are being complied with in the counting and listing processes.

A block of sequential prenumbered inventory sheets will be issued to each supervisor at 8:00 a.m., August 5, for later issuance to count teams. Each supervisor is to account for all sheets—used, unused, or voided. In addition, each supervisor will be furnished at that time with a listing of count teams under his or her supervision.

When a count team reports completion of a department, that team's supervisor should accompany a representative of the independent auditors, McDonald & Company, in performing test counts. A space is provided on each inventory sheet for the supervisor's signature as reviewer. When the independent auditors have "cleared" a department, the supervisor responsible should take possession of the count sheets. All completed count sheets are to be placed in numerical sequence and turned over to me when the entire inventory has been completed.

Before supervisors and employees leave the stores Saturday evening, August 4, they are to make certain that "housekeeping" is in order in each department and that all merchandise bears a price ticket.

If you have any questions about these instructions or any other aspect of the physical inventory, please see me.

J. R. Adams

J. R. Adams
Controller
July 24, 20X0

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Completeness	☒
Rights	☒
Valuation	☒
Cutoff	☒

is to help ensure that all auditors understand their assignments and can therefore work efficiently during the physical inventory. Figure 12.5 provides an example of such instructions.

3. Observe the Taking of Physical Inventory and Make Test Counts.

It is not the auditors' function to *take* the inventory or to control or supervise the taking; this is the responsibility of management. The auditors' responsibility is to *observe* the inventory taking. However, to observe the inventory taking implies a much more active role than that of a mere spectator.

The auditors' responsibility is to attend the physical inventory counting by the client and

- Inspect the inventory to determine its existence and condition, and make test counts.
- Observe compliance with management's instructions for taking the inventory.
- Obtain audit evidence about the reliability of the count procedures.

FIGURE 12.5
Inventory Observation
Instructions

MCDONALD & COMPANY <i>Certified Public Accountants</i>		
Glen Haven Department Stores, Inc. Inventory Observation—Instructions for Audit Staff August 1, 20X0		
We will observe physical inventory taking at the following stores of Glen Haven Department Stores, Inc., on August 5, 20X0.		
Store	Store Manager	Our Staff
Wilshire	J. M. Baker	John Rodgers, Faye Arnold
Crenshaw	Roberta Bryan	Weldon Simpkins
Valley	Hugh Remington	Roger Dawson
Report to assigned stores promptly at 8:00 a.m. Attached are copies of the company's detailed instructions to employees who are to take the physical inventories and to supervisors who are to be in charge. These instructions appear to be complete and adequate; we should satisfy ourselves by observation that the instructions are being followed.		
All merchandise counted will be listed on prenumbered inventory sheets. We should make test counts of approximately 5 percent of the stock items to ascertain the accuracy of the physical counts. A majority of the counts should be performed on the high-value stock, as described on the enclosed listing. Test counts are to be recorded in working papers, with the following information included:		
Department number Inventory sheet number Stock number Description of item Quantity Selling price per price tag		
We should ascertain that adequate control is maintained over the prenumbered inventory sheets issued. Also, we should prepare a listing of the last numbers used for transfers, markdowns, and markups in the various departments and stores. Inventory sheets are not to be removed from the departments until we have "cleared" them; we should not delay this operation.		
Each staff member's working papers should include an opinion on the adequacy of the inventory taking. The papers should also include a summary of time incurred in the observation.		
No cash or other cutoff procedures are to be performed as an adjunct to the inventory observation.		



Illustrative Case

Drones for Audit of Inventories

Certain inventories historically have been difficult to observe by auditors; for example, inventory stored in massive warehouses, inventory stored in storage

tanks, and large mineral deposits, particularly those at remote locations. Like their clients, CPA firms are increasingly using drones equipped with imaging technology to “observe” such inventories in warehouses or in remote or hard-to-access areas.

Throughout this process, the auditors seek to determine that all usable inventory owned by the client is included in the count, as well as to be alert to the possibility of inclusion of any obsolete or damaged merchandise in inventory.

Excessive dust or rust on raw materials inventory items may be indicative of obsolescence or infrequent sale. Such merchandise should be segregated by the client and written down to its net realizable value.

The auditors also will *record the serial number of the final receiving and shipping documents issued before the taking of inventory* so that the accuracy of the cutoff can be determined at a later date. Shipments or receipts of goods taking place during the counting process should be closely observed and any necessary reconciliations made. Observation of the physical inventory by the auditors also stresses determining that the client is controlling the inventory tags or sheets properly. These should be prenumbered so that all tags or sheets can be accounted for. If the client is using scanning procedures, the auditors should make sure the procedures help assure that all items are counted and none are counted twice.

During the inventory observation, the auditors will make test counts of selected inventory items. The extent of the test counts will vary widely, depending upon the levels of the risks of material misstatement and the materiality of the client’s inventory. A representative number of test counts should be recorded in the audit working papers for subsequent comparison with the completed inventory listing.

In some cases, some inventory items may be difficult to observe because of their location—for example, the items may be located on elevated shelves in large warehouses. Auditors should bear in mind that items that are difficult to test count are also difficult for the client’s staff to accurately count. Therefore, the auditors should take representative test counts of items regardless of their location. In certain cases, the auditors may find it useful to use drones to assist in performing test counts of items that are difficult to access.

If the inventory does not already have bar codes, radio frequency identification tags, or other types of identification tags, serially numbered (or computer-generated) inventory count tags are usually attached to each lot of goods during the taking of a physical inventory. The design of the tag and the procedures for using it are intended to guard against two common pitfalls: (a) accidental omission of goods from the count and (b) double-counting of goods.

Many companies use two-employee teams to count the inventories. Each team is provided with a sequence of the serially numbered tags and is required to return to the physical inventory supervisor any voided or unused tags.

The actual counting, including the scanning of identification codes or filling in and pulling the identification tags, is done by the client’s employees. While the inventory tags are still attached to the goods, the auditors may make such test counts as they deem appropriate in the circumstances. The auditors will list in their working papers the inventory IDs or tag numbers, inventory descriptions, and the auditors’ counts. The client employees will not ordinarily collect (pull) the inventory tags until the auditors indicate that they are satisfied with the accuracy of the count.

In comparing their test counts to the inventory tags or sheets, the auditors are alert for errors not only in quantities but also in part numbers, descriptions, units of measure, and all other aspects of the inventory item. For test counts of goods in process inventory, the



Illustrative Case

Fraudulent Misstatement of Inventories



Unscrupulous management has used a variety of methods to misstate inventories. In general, these schemes are used to overstate inventory and thereby understate cost of goods sold, thus overstating net income. One method involved recording fictitious inventory, sometimes in such quantities that the resulting total recorded inventory was in excess of the company's storage capacity. Another method involved placing scrap materials in product boxes to be counted as inventory. **Bill and hold** schemes may only record the sale and retain the items in year-end inventory

totals. Also, double-counting of inventory (including it in more than one warehouse's count) may occur.

The ways in which management has circumvented the auditors' tests also have varied. In one instance, fictitious count sheets were created. In another situation, client personnel obtained knowledge of the items tested by the auditors and increased the recorded quantities of items not tested. Finally, client personnel have actually gained access to the auditors' working papers and altered them to support the fictitious inventory.

These cases illustrate the need for extreme care by the auditors in planning and performing inventory procedures.

auditors should determine that the percentage or stage of completion indicated on the inventory tag is appropriate.

If the test counts made by the auditors indicate discrepancies, the goods are recounted at once by the client's employees and the error corrected. If an excessive number of errors are found, the auditors should consider requesting the client to recount particular areas.

The client often transfers the information listed on the inventory tags to serially numbered inventory sheets. These sheets are used in pricing the inventory and in summarizing the dollar amounts involved. After the inventory tags have been collected, the client employee supervising the inventory determines that all tags are accounted for by serial number. The auditors should ascertain that numerical control is maintained over both inventory tags and inventory sheets.

Clients using electronic equipment may facilitate inventory counting and summarizing through machine-readable inventory tags. Prior to the physical inventory, the tags may be encoded with tag numbers, part numbers, descriptions, and unit prices. After the physical inventory, the information from the tags is scanned into the computer, which extends quantity times unit price for each inventory item and prints out a complete inventory summary. In these situations, the auditors may use mobile devices to read the tags and record their test counts.

The test counts and tag numbers listed by the auditors in their working papers will be traced later to the client's inventory summary sheets. A discrepancy will be regarded not as an error in counting but as a mistake in copying data from the tags, a purposeful alteration of a tag, or the creation of a fictitious tag.

During the observation of physical inventories, the auditors should make inquiries to determine whether any of the materials or goods on hand are the property of others, such as goods held on **consignment** or customer-owned materials sent in for machine work or other processing.

Audit procedures applicable to goods held by the client on consignment may include a comparison of the physical inventory with the client's records of consigned goods on hand, review of contracts and correspondence with consignors, and direct written communication with the consignors to (1) confirm the quantity and value of goods held at the balance sheet date and (2) disclose any client liability for unremitted sales proceeds or from inability to collect consignment accounts receivable.

Each auditor participating in the observation of the inventory will prepare working papers. These papers should indicate the extent of test counts, describe any deficiencies noted, and express a conclusion as to whether the physical inventory appeared to have

FIGURE 12.6
Documentation of
Physical Inventory
Observation

THE WILSHIRE CORPORATION Comments on Observation of Physical Inventory	D-9
December 31, 20X0	
1. Advance Planning of Physical Inventory. A physical inventory was taken by the client on December 31, 20X0. Two weeks in advance of this date we reviewed the written inventory instructions prepared by L. D. Frome, Controller. These instructions appeared entirely adequate and reflected the experience gained during the counts of previous years. The plan called for a complete closing down of the factory on December 31, since the preceding year's count had been handicapped by movements of productive material during the counting process. Training meetings were conducted by Frome for all employees assigned to participate in the inventory; at these meetings the written instructions were explained and discussed.	
2. Observation of Physical Inventory. We were present throughout the taking of physical inventory on December 31, 20X0. Prior to the count, all materials had been neatly arranged, labeled, and separated by type. Two-employee inventory teams were used: one employee counting and calling quantities and descriptions; the other employee filling in data on the serially numbered inventory tags. As the goods were counted, the counting team tore off the "first count" portion of the inventory tag. A second count was made later by another team working independently of the first; this second team recorded the quantity of its count on the "second count" portion of the tag. We made test counts of numerous items, covering approximately 60 percent of the total inventory value. These counts were recorded on our working papers and used as noted below. Our observation throughout the plant indicated that both the first and second counts required by the inventory instructions were being performed in a systematic and conscientious manner. The careful and alert attitude of employees indicated that the training meetings preceding the count had been quite effective in creating an understanding of the importance of an accurate count. Before the "second count" portions of the tags were removed, we visited all departments in the company with Frome and satisfied ourselves that all goods had been tagged and counted. No goods were shipped on December 31. We ascertained that receiving reports were prepared on all goods taken into the receiving department on this day. We recorded the serial numbers of the last receiving report and the last shipping advice for the year 20X0. (See D-9-1.) We compared the quantities per the count with perpetual inventory records and found no significant discrepancies.	
3. Quality and Condition of Materials. Certain obsolete parts had been removed from stock prior to the count and reduced to a scrap carrying value. On the basis of our personal observation and questions addressed to supervisors, we have no reason to believe that any obsolete or defective materials remained in inventory. During the course of inventory observation, we tested the reasonableness of the quantities of 10 items, representing 40 percent of the value of the inventory, by comparing the quantity on hand with the quantity used in recent months; in no case did we find that the quantity in inventory exceeded three months' normal usage.	
V.M.H. Jan. 3, 20X1	

been properly taken in accordance with the client's instructions. The auditor-in-charge should prepare a concise summary memorandum indicating the overall extent of observation and the percentage of inventory value covered by quantity tests. The memorandum also may include comments on the consideration given to the factors of quality and condition of stock, the treatment of consigned goods on hand, and the control of shipments and receipts during the counting process. Figure 12.6 illustrates this type of memorandum.

Outside Inventory-Taking Firms

Some clients may hire firms that specialize in taking physical inventories for other organizations. As an example, retail store chains often hire these firms to take physical inventories of the company's individual stores. The inventory-taking firm typically counts, lists, prices, and subsequently values the inventory on hand at the date of the physical count. Even though these firms may be independent of client personnel, the counts made

by these firms are not, by themselves, sufficient appropriate audit evidence regarding the client's inventory. The auditors should evaluate the effectiveness of the procedures used by the outside firm and perform other procedures as outlined in the preceding sections as considered appropriate.

Inventories in Public Warehouses and on Consignment

Companies that store inventories in public warehouses ordinarily receive receipts for those goods. Examination of these receipts is not sufficient verification of goods stored in public warehouses. Both the AICPA and the PCAOB have recommended direct confirmation in writing from outside custodians of inventories and supplementary procedures when the amounts involved represent a significant proportion of the current assets or of the total assets of a concern. These supplementary procedures include review of the client's procedures for investigating prospective warehouses and evaluating the performance of warehouses having custody of the client's goods. The auditors also should consider obtaining accountants' reports on the warehouses' controls relevant to custody of stored goods. If the amounts are material, or if any reason for doubt exists, the auditors may decide to visit the warehouses and observe a physical inventory of the client's merchandise stored at the warehouses.

A starting point for the verification of goods in the hands of consignees is to obtain from the client a list of all consignees and copies of the consignment contracts. Contract provisions concerning the payment of freight and other handling charges, the extension of credit, computation of commissions, and frequency of reports and remittances require close attention. After review of the contracts and the client's records of consignment shipments and collections, the auditors should communicate directly with the consignees and obtain full written information on consigned inventory, receivables, unremitted proceeds, and accrued expenses and commissions as of the balance sheet date.

Often, the client may own raw materials that are processed by a subcontractor before being used in the client's production process. The auditors should request the subcontractor to confirm quantities and descriptions of client-owned materials in the subcontractor's possession.

Inventory Verification When Auditors Are Engaged after the End of the Year

A company desiring an independent audit should engage the auditors well before the end of the year so they can participate in advance planning of the physical inventory and be prepared to observe the actual counting process. Occasionally, however, auditors are not engaged until after the end of the year and therefore find it impossible to observe the taking of inventory at the close of the year. For example, the illness or death of a company's individual practitioner CPA near the year-end might lead to the engagement of new auditors shortly after the balance sheet date.

Under these circumstances, the auditors may conclude that sufficient appropriate evidence cannot be obtained concerning inventories to permit them to express an opinion on the overall fairness of the financial statements. On the other hand, under other circumstances, the auditors may be able to obtain satisfaction concerning the inventories by alternative auditing procedures. These favorable circumstances might include the existence of strong internal control, perpetual inventory records, availability of instructions and other records showing that the client had carried out a well-planned physical inventory at or near the year-end, and the making of test counts by the newly appointed auditors. If the auditors are to express an unqualified opinion, their investigation of inventories should include some physical contact with items of inventory and should be thorough enough to compensate for the fact that they were not present when the physical inventory was taken. Whether such alternative auditing procedures will be feasible and will enable the auditors to satisfy themselves depends upon the circumstances of the particular engagement.

4. Review the Year-End Cutoff of Purchases and Sales Transactions.

An accurate cutoff of purchases is one of the most important factors in verifying the existence and completeness of the year-end inventory. It requires that items for which

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Rights	☒
Valuation	☒
Cutoff	☒

the company holds title as of year-end be included in inventory as well, and that related accounts be properly stated. Assume that a shipment of goods costing \$10,000 is received from a supplier on December 31, but the purchase invoice does not arrive until January 2 and is entered as a January transaction. If the goods are included in the December 31 physical inventory but there is no December entry to record the purchase and the liability, the result will be an overstatement of both net income for the year and retained earnings and an understatement of accounts payable, each error being in the full amount of \$10,000 (ignoring income taxes).

An opposite situation may arise if a purchase invoice is received and recorded on December 31, but the merchandise covered by the invoice is not received until several days later and is not included in the physical inventory taken at year-end. The effect on the financial statements of recording a purchase without including the goods in the inventory is to understate net income, retained earnings, and inventory.

How can the auditors determine that the liability to suppliers has been recorded for all goods included in inventory? Their approach is to *examine on a test basis the purchase invoices and receiving reports for several days before and after the inventory date*. Each purchase invoice in the files should have a receiving report attached; if an invoice recorded in late December is accompanied by a receiving report dated December 31 or earlier, the goods must have been on hand and included in the year-end physical inventory. However, if the receiving report carried a January date, the goods were not included in the physical count made on December 31.

A supplementary approach to the matching of purchase invoices and receiving reports is to examine the records of the receiving department. For each shipment received near year-end, the auditors should determine that the related purchase invoice was recorded in the same period.

The effect on the financial statements of failing to include a year-end in-transit purchase as part of physical inventory is often not a serious one, *provided* the related liability is not recorded until the following period. In other words, a primary point in effecting an accurate cutoff of purchases is that both sides of a purchase transaction must be reflected in the same accounting period. If a given shipment is included in the year-end physical inventory of the purchaser, the entry debiting Inventories and crediting Accounts Payable must be made. If the shipment is not included in the purchaser's year-end physical inventory, the purchase invoice must not be recorded until the following period.

Adjustments to achieve an accurate cutoff of purchases should, of course, be made by the client's staff; the function of the auditors should be to review the cutoff and determine that the necessary adjustments have been made.

Chapter 11 includes a discussion of the audit procedures for determining the accuracy of the sales cutoff. The sales cutoff is mentioned again at this point to emphasize its importance in determining the fairness of the client's inventory and cost of goods sold as well as accounts receivable and sales.

5. Obtain a Copy of the Completed Physical Inventory, Test Its Clerical Accuracy, and Trace Test Counts.

The testing of extensions and footings on the final inventory listing may disclose misstatements of physical inventories. Often this test consists of "sight-footing" to the nearest hundred dollars or thousand dollars of the inventory listings. Generalized audit software also may be used to test extensions and footings.

In testing extensions, the auditors should be alert for two sources of substantial errors: misplaced decimal points and the incorrect extension of *count* units by *price* units. For example, an inventory listing that extends 1,000 units times \$1C (per hundred) as \$1,000 will be overstated by \$990. An inventory extension of 1,000 sheets of steel times \$5 per pound will be substantially understated if each sheet of steel weighs more than one pound.

The auditors also should trace to the completed physical inventory their test counts made during the observation of physical inventory. During this tracing, the auditors should be alert for any indications that inventory tags have been altered or that fictitious

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Completeness	☒
Rights	☒
Valuation	☒
Cutoff	☒



Illustrative Case

Fraudulent Financial Reporting at U.S. Foodservices



An alleged fraud at U.S. Foodservices (USF) provides an illustration of the often complex

nature of inventory valuation. In a typical promotional allowance arrangement, USF would pay the full wholesale price for a product and then receive rebates of a portion of the price from the supplier if certain purchase volume and other conditions were met.

To meet earnings targets, federal prosecutors charged that nine former USF employees overstated the promotional allowances (and earnings) by more than \$800,000,000. To hide the fraud, USF convinced suppliers to return confirmations to auditors confirming the fraudulent amounts.

Participation by the suppliers makes this sort of fraud extremely difficult—and, perhaps, impossible—for auditors to detect. It is possible that industry knowledge would lead the auditors to question the large amount of allowances. Also, if details of the computation of allowances are included in sales agreements, the auditors could calculate the proper amounts and compare them with the recorded amounts. However, if the allowances are based on unwritten side agreements between the parties, examining agreements will not be effective in detecting the misstatements. Certainly, subsequent years' results will reveal the misstatements.

inventory tags have been created. The auditors also reconcile inventory tag number sequences in the physical inventory listing to tag numbers noted in their audit working papers for the inventory observation. This procedure is designed to determine that the client has not omitted inventory items from the listing or included additional items that were not present during the physical inventory.

Another test of the clerical accuracy of the completed physical inventory is the reconciliation of the physical counts to inventory records. Both the quantities and the values of the items should be compared to the company's perpetual records. The totals of various sections of inventory also should be compared with the corresponding control accounts. All substantial discrepancies should be investigated fully. The number, type, and cause of the discrepancies revealed by such comparisons are highly significant in assessing control risk for inventories.

Primary Audit Objective:

Valuation ☒

6. Evaluate the Bases and Methods of Inventory Pricing.

The auditors are responsible for determining that the bases and methods of pricing inventory are in accordance with generally accepted accounting principles. The investigation of inventory pricing often will emphasize the following three questions:

1. What method of pricing does the client use?
2. Is the method of pricing the same as that used in prior years?
3. Has the method selected by the client been applied consistently and accurately in practice?

For the first question—the method of pricing—a long list of options is possible, including such methods as cost; cost or market, whichever is lower; the retail method; and quoted market price (as for metals and staple commodities traded on organized exchanges). The cost method, of course, includes many diverse systems, such as last-in, first-out (LIFO); first-in, first-out (FIFO); specific identification; weighted average; and standard cost. It is important to note that the international accounting standards do not allow the use of LIFO as a method for pricing inventory.

The second question raised in this section concerns a change in method of pricing inventory from one year to the next. For example, let us say that the client has changed from the FIFO method to the LIFO method. The nature and justification of the change in method of valuing inventory and its effect on income should be disclosed. In addition, the auditors should insert in the audit report an explanatory paragraph concerning the lack of consistency between the two years.

FIGURE 12.7 Test of Inventory Pricing

The Wilshire Corporation Test of Pricing—Raw Materials and Purchased Parts December 31, 20X0							D-5
Part No.	Description	Per Inventory Quantity/Price	Per Vendor's Invoice				
			Vendor	Date	No.	Quantity @ Price	
82 182	Aluminum 48 x 144 x .025	910 sheets @ 10.10	Hardy & Co.	Dec. 18, X0	5415	1000 @ 10.10	y
82 195	Aluminum 45/72 x .032	804 sheets @ 9.01	Watson Mfg. Co.	Nov. 28, X0 Dec. 22, X0	3201 3456	500 @ 9.01 400 @ 9.01	y y
K1125	Stainless steel .025 x 23	80,625 lbs @ .80	Ajax Steel Co.	Dec. 3, X0	K182	100,000 @ .80	y
K1382	Stainless steel .031 x 17	65,212 lbs @ .82	Ajax Steel Co.	Dec. 3, X0	K182	75,000 @ .82	y
XL3925	10 H.P. Electronic Motor	50 units @ 400.00	Cronyn Mfg. Co.	Nov. 18, X0	D2532	100 @ 400.00	y
XJ3824	3/4 H.P. Electronic Motor	645 units @ 30.50	Long & Co.	Dec. 29, X0	E9215	650 @ 30.50	y

Inventory value of raw materials and purchased parts selected for price testing—\$301,825.56.

Percent of total raw materials and purchased parts selected for price testing—\$301,825.56/\$503,615.10 = 60%.

See audit plan B-4 for method of selecting raw materials and purchased parts for price testing.

y = Agreed to prices on the vendor's invoice.

Conclusion:

Based on our tests, the pricing of raw materials and purchased parts appears to be materially correct.

CMB
1/4/X1

The third question posed deals with consistent accurate application in practice of the method of valuation adopted by the client. To answer this question, the auditors should test the pricing of a representative number of inventory items.

Primary Audit Objectives:	
Valuation	☒
Accuracy	☒

7. Test the Pricing of Inventories.

The testing of prices applied to inventories of raw materials, purchased parts, and supplies by a manufacturing company is similar to the testing of prices of merchandise in a trading business. In both cases, the cost of inventory items, whether LIFO, FIFO, weighted average, or specific identification, is readily verified by reference to purchase invoices. An illustration of a computerized working paper prepared by an auditor in making price tests of an inventory of raw materials and purchased parts is presented in Figure 12.7.

Audit procedures for verification of the inventory values assigned to goods in process and finished goods are not so simple and conclusive as in the case of raw materials or merchandise for which purchase invoices are readily available. To determine whether the inventory valuation method used by the client has been properly applied, the auditors should make tests of the pricing of selected items of finished goods and goods in process. The pricing of these items should be tested by reference to the client's cost accounting records of accumulated direct material, direct labor, and manufacturing overhead costs. Items of large total value will be selected for testing so that the tests will encompass a significant portion of the dollar amount of inventories.

Lower-of-Cost-or-Market Test

As a general rule, inventories should not be carried at an amount in excess of net realizable value. Under U.S. generally accepted accounting standards, the lower-of-cost-or-market

rule is used to measure any loss of utility in the inventories. This test generally involves comparing recorded cost of inventory items with their replacement cost, within the ceiling (net realizable value) and the floor (net realizable value minus normal profit).

Under international accounting standards, the recorded costs of the items are compared to their net realizable values. Also, under international standards, the inventory items may be written back up if the value subsequently recovers.

8. Perform Analytical Procedures or Data Analytics.

Material misstatements of inventory may be disclosed by analytical procedures designed to establish the general reasonableness of inventory figures. As an example, major increases or decreases in the amounts of various types of inventory as compared to prior-year amounts may be identified and investigated.

In certain lines of business, particularly retail and wholesale companies, gross profit margins may be quite uniform from year to year. Any major difference between the ending inventory estimated by the gross profit percentage method and the count of inventory at year-end should be investigated fully. If the client has inventory in a number of stores, some of which were not visited by the auditors, comparing gross profit by store may reveal overstatements in those not visited.

Primary Audit Objectives:	
Existence	☒
Rights	☒
Valuation	☒
Accuracy	☒

Focus on the Computer Hardware and Software Industry

Given the pace of technological advances and the highly competitive nature of the computer hardware and software industry, rapid inventory obsolescence is common. Product life cycles are typically short and competitive products with superior price and performance can quickly enter the marketplace. Analytical procedures may be used to determine whether inventory amounts and trends appear proper. However, simply making comparisons of the current year's amounts and ratios to those of prior years is not effective. The auditors should consider what is expected to happen in the industry. In developing expected amounts for analytical procedures, consideration should be given to expected future demand for the client's products and anticipated technological advances that render existing inventories obsolete. The auditors may find analyses of management's sales forecasts useful for this purpose.

The auditors' analytical procedures for inventory transactions often will include a comparison of the volume of purchase transactions from period to period. Comparisons of transactions, classified by vendor and type of product, may reveal unusual variations of quantities purchased or unusual concentrations of purchases with particular vendors, indicating possible conflicts of interest. The auditors also may use analytical procedures to identify obsolete inventories. Rates of inventory turnover may be compared with rates prevailing in prior years. A decreasing rate of turnover suggests the possibility of obsolescence or of unnecessarily large amounts of inventories. Scanning perpetual inventory records also may reveal obsolete items. In performing analytical procedures related to inventories and cost of goods sold, the auditors also may review ledgers and journals for unusual entries or amounts that may be indicative of errors, fraud, or other material issues.

Using nonfinancial information for developing expectations for analytical procedures can be especially effective for inventories. For example, when the client has inventory stored in a number of warehouses, the auditor may compare the amount of inventory stored in each warehouse with its size in square feet. Comparisons also can be made between inventory in dollars and in units, and, for a manufacturing firm, inventory and cost of goods sold amounts may be compared to various production statistics, such as direct labor-hours and machine-hours.

Much of the evidence historically provided by analytical procedures may be more efficiently and thoroughly provided with the use of data analytics. Data analytics software may be used to examine 100 percent of inventory items, transactions, or entries in

journals and ledgers using the criteria specified by the auditors. As examples, the auditors may

1. Identify overvalued inventory items by comparing cost per unit to current sales prices or net realizable values.
2. Identify obsolete inventory items by comparing actual or forecasted sales to number of items in inventory.
3. Identify obsolete parts by searching for components of manufactured products that are no longer being made.
4. Identify overstocked (and understocked) inventory items by comparing numbers of items in inventory to target stocking levels.
5. Identify high-value items (and their locations) to be included in test counts performed during inventory observation.
6. Identify locations to be selected for inventory observation in a multiple-location audit by searching for unusual relationships, such as a location that has unusually high or low sales in relation to inventory levels.
7. Identify inventories purchased (a) without proper approval or (b) from unusual or related parties.

Primary Audit Objectives:	
Valuation	☒
Presentation	☒

9. Determine Whether Any Inventories Have Been Pledged and Review Purchase and Sales Commitments.

The verification of inventories includes a determination by the auditors as to whether any goods have been pledged or subjected to a lien of any kind. Pledging of inventories to secure bank loans may be brought to light when bank balances and indebtedness are confirmed.

A record of outstanding **purchase commitments** is usually readily available because this information is essential to management in maintaining day-to-day control of the company's inventory position and cash flow.

In some lines of business, it is customary to enter into firm contracts for the purchase of merchandise or materials well in advance of the scheduled delivery dates. Comparison by the auditors of the prices quoted in such commitments with the vendors' prices prevailing at the balance sheet date may indicate substantial losses if firm purchase commitments are not protected by firm sales contracts. Such losses should be reflected in the financial statements.

The quantities of purchase commitments should be reviewed in the light of current and prospective demand, as indicated by past operations, the backlog of sales orders, and current conditions within the industry. If quantities on order appear excessive by these standards, the auditors should seek full information on this phase of operations. Purchase commitments may need to be disclosed in the financial statements.

Sales commitments are indicated by the client's *backlog* of unfilled sales orders. Losses inherent in firm sales commitments are generally recognized in the lower-of-cost-or-market valuation of inventories, with *market* being defined as the net realizable value of the goods in process or finished goods inventories applicable to the sales commitments. In addition, the backlog may include sales orders for which no production has been started as of the balance sheet date. The auditors should review the client's cost estimates for these sales orders. If estimated total costs to produce the goods ordered exceed fixed sales prices, the indicated loss and a related liability should be recorded in the client's financial statements for the current period.

Primary Audit Objective:	
Presentation	☒

10. Evaluate Financial Statement Presentation of Inventories and Cost of Goods Sold, Including the Adequacy of Disclosure.

One of the most important factors in proper presentation of inventories in the financial statements is disclosure of the inventory pricing method or methods in use. Other important disclosures include the following:

- Changes in methods of valuing inventory, with the dollar effect and justification for the change reported.

- The various classifications of inventory, such as finished goods, work in process, and raw materials.
- The details of any arrangements relating to any pledged inventory.
- Deduction of valuation allowance for inventory losses.
- Existence and terms of inventory purchase commitments.

The auditors will review the client's disclosures of such matters to determine whether they comply with generally accepted accounting principles.

Problems Associated with Inventory of First- Year Audit Clients

The need for the auditors to be present to observe the taking of the ending inventory has been strongly emphasized in auditing literature. However, the figure for beginning inventory is equally significant in determining the cost of goods sold and the net income for the year. In the initial audit of a client, the auditors may not have been present to observe the taking of inventory at the beginning of the year. What procedures can they follow to obtain evidence that the beginning inventories are fairly stated?

The first factor to consider is whether another CPA firm audited the client for the preceding year. If a review of the predecessor firm's working papers indicates compliance with generally accepted auditing standards, the new auditors can accept the beginning inventories with a minimum of investigation. That minimum might include the following steps: (1) study of the inventory valuation methods used; (2) review of the inventory records; (3) review of the inventory sheets used in taking the preceding year's physical inventory; and (4) comparison of the beginning and ending inventories, broken down by product classification. If there was no satisfactory audit for the preceding year, the investigation of the beginning inventories would include not only the procedures mentioned in the preceding paragraph but also the following steps: (1) discussion with the person in the client's organization who supervised the physical inventory at the preceding balance sheet date; (2) study of the written instructions used in planning the inventory; (3) tracing of numerous items from the inventory tags or count sheets to the final summary sheets; (4) tests of the perpetual inventory records for the preceding period by reference to supporting documents for receipts and withdrawals; and (5) tests of the overall reasonableness of the beginning inventories in relation to sales, gross profit, and rate of inventory turnover. An investigation along these lines will sometimes give the auditors assurance that the beginning inventory was carefully compiled and reasonable in amount; in other cases, these procedures may raise serious doubts about the validity of the beginning inventory figure. In these latter cases, the auditors will not be able to issue an unqualified opinion as to *statements of income and cash flows*. They may be able, however, to give an unqualified opinion on the *balance sheet* because this financial statement does not reflect the beginning inventories.

Chapter Summary

This chapter described details of the controls over inventories and cost of goods sold, the auditors' consideration of these controls, and substantive procedures for inventories and cost of goods sold. To summarize:

1. The audit of inventories presents the auditors with special risks because (a) they often represent a very substantial portion of current assets; (b) numerous valuation methods are used for inventories; (c) the valuation of inventories directly affects cost of goods sold; and (d) the determination of inventory quality, condition, and value is inherently complex.
2. Effective internal control over inventories requires appropriate controls over purchasing, receiving, and issuing supplies and materials; producing and shipping products; and cost accounting. A perpetual inventory system is also important.
3. The auditors' objectives for the substantive procedures for inventories and cost of goods sold are to (a) substantiate the existence of inventories and the occurrence

- of related transactions, (b) establish the completeness of recorded inventories; (c) verify the cutoff of inventory-related transactions, (d) determine that the client has rights to the recorded inventories, (e) establish the proper valuation of inventories and accuracy of related transactions, and (f) determine that presentation and disclosures of inventory accounts are appropriate.
4. The auditors' consideration of inherent risks and the controls over inventories, purchases, and production will allow them to design appropriate further audit procedures for inventory and cost of goods sold accounts.
 5. In the audit of inventories, a primary concern of the auditors is existence assertion, that is, the possibility of overstatement of year-end balances. Therefore, a primary substantive procedure for inventory accounts is observation of the client's physical inventory. Other substantive procedures include price tests of the valuation of inventory items, cutoff tests, analytical procedures, and tests of the financial statement presentation and disclosure.

Key Terms Introduced or Emphasized in Chapter 12

Bill and hold (608) Transactions in which sales of merchandise are billed to customers prior to delivery, with the goods being held by the seller. These transactions may overstate revenues and net income if they do not meet specific requirements for recognition as sales.

Bill of lading (595) A document issued by a common carrier acknowledging the receipt of goods and setting forth the provisions of the transportation agreement.

Consignment (608) A transfer of goods from the owner to another person who acts as the sales agent of the owner.

Cost Accounting Standards Board (602) A five-member board established by Congress to narrow the options in cost accounting that are available under generally accepted accounting principles. Companies having significant supply contracts with certain U.S. government agencies are subject to the cost accounting standards established by the board.

Electronic data interchange (EDI) (596) A system in which data are exchanged electronically between the computers of different companies. In an EDI system, source documents are replaced with electronic transactions created in a standard format.

Job time tickets (594) A document designed to accumulate the labor and machine time devoted to a particular production order.

Management review controls (592, 602) Reviews conducted by management of estimates and other kinds of financial information for reasonableness. They often involve the use of significant judgment, knowledge, and experience in comparing recorded amounts with expectations of the reviewers. They often are considered monitoring controls but may relate to any of the other COSO components that have the common characteristic of management review of information to identify misstatements or breakdowns in other controls.

Master production schedule (594) A schedule that is used to plan overall production for a period of time. The schedule illustrates the gross production of each of the company's products.

Observation (590) The auditors' evidence-gathering technique of viewing a client activity to obtain physical evidence of performance.

Periodic inventory system (590) A method of accounting in which inventories are determined solely by means of a physical inventory at the end of the accounting period.

Perpetual inventory system (590) A method of accounting for inventories in which controlling accounts and subsidiary ledgers are maintained to record receipts and issuances of goods, both in quantities and in dollar amounts. The accuracy of perpetual inventory records is tested periodically by physical inventories.

Production order (594) A document that authorizes the production of a specific quantity of a product.

Purchase commitment (615) A contractual obligation to purchase goods at fixed prices, entered into well in advance of scheduled delivery dates.

Sales commitment (615) A contractual obligation to sell goods at fixed prices, entered into well in advance of scheduled delivery dates.

Specialist (604) A person possessing special skill or knowledge in a field other than accounting or auditing, such as a real estate appraiser.

Review Questions

- 12-1. Many auditors consider the substantiation of the figure for inventory to be a more difficult and challenging task than the verification of most other items on the balance sheet. List several specific factors that support this view.
- 12-2. Explain the significance of the purchase order to adequate internal control over purchase transactions.
- 12-3. What segregation of duties would you recommend to attain maximum internal control over purchasing activities in a manufacturing concern?
- 12-4. Do you believe that the normal review of purchase transactions by the auditors should include examination of receiving reports? Explain.
- 12-5. The client's cost accounting system is often an important part of the CPAs' audit of the financial statements of a manufacturing company. For what purposes do the auditors consider the cost accounting system?
- 12-6. What part, if any, do the independent auditors play in the planning for a client's physical inventory?
- 12-7. What are the purposes of the auditors' observation of the taking of the physical inventory? (Do not discuss the procedures or techniques involved in making the observation.)
- 12-8. For what purposes do the auditors make and record test counts of inventory quantities during their observation of the taking of the physical inventory? Discuss.
- 12-9. Once the auditors have completed their test counts of the physical inventory, will they have any reason to make later reference to the inventory tags used by the client's employees in the counting process? Explain.
- 12-10. When perpetual inventory records are maintained, is it necessary for a physical inventory to be taken at the balance sheet date? Explain.
- 12-11. What is meant by a "bill and hold" scheme?
- 12-12. What charges and credits may be disclosed in the auditors' analysis of the Cost of Goods Sold account of a manufacturing concern?
- 12-13. A client company wishes to conduct its physical inventory on a sampling basis. Many items will not be counted. Under what general conditions will this method of taking inventory be acceptable to the auditors?
- 12-14. Hana Ranch Company, which has never been audited, is asked on October 1 by its bank to arrange for a year-end audit. The company retains you to make this audit and asks what measures, if any, it should take to ensure a satisfactory year-end physical inventory. Perpetual inventories are not maintained. How would you answer this inquiry?
- 12-15. "A well-prepared balance sheet usually includes a statement that the inventories are valued at cost." Evaluate this quotation.
- 12-16. Darnell Equipment Company uses the LIFO method of valuation for part of its inventories and weighted-average cost for another portion. Would you be willing to issue an unqualified opinion under these circumstances? Explain.
- 12-17. "If the auditors can determine that all goods in the physical inventory have been accurately counted and properly priced, they will have discharged fully their responsibility with respect to inventory." Evaluate this statement.
- 12-18. How do the independent auditors use the client's backlog of unfilled sales orders in the examination of inventories?
- 12-19. The controller of a new client company informs you that most of the inventories are stored in bonded public warehouses. He presents warehouse receipts to account for the inventories. Will careful examination of these warehouse receipts constitute adequate verification of these inventories? Explain.
- 12-20. Enumerate specific steps to be taken by the auditors to ascertain that a client's inventories have not been pledged or subjected to a lien of any kind.

Select questions are available with Connect



- 12-21. Warren Manufacturing Company retains you on April 1 to perform an audit for the fiscal year ending June 30. During the month of May, you make extensive studies of internal control over inventories.

All goods purchased pass through a receiving department under the direction of the chief purchasing agent. The duties of the receiving department are to unpack, count, and inspect the goods. The quantity received is compared with the quantity shown on the

Questions Requiring Analysis

LO 12-5

receiving department's copy of the purchase order. If there is no discrepancy, the purchase order is stamped "OK—Receiving Dept." and forwarded to the accounts payable section of the accounting department. Any discrepancies in quantity or variations from specifications are called to the attention of the buyer by returning the purchase order to him with an explanation of the circumstances. No records are maintained in the receiving department, and no reports originate there.

As soon as goods have been inspected and counted in the receiving department, they are sent to the factory production area and stored alongside the machines in which they are to be processed. Finished goods are moved from the assembly line to a storeroom in the custody of a stock clerk, who maintains a perpetual inventory record in terms of physical units but not in dollars.

What weaknesses, if any, do you see in the internal control over inventories?

- LO 12-1, 2, 6** 12-22. Many companies employ outside service companies that specialize in counting, pricing, extending, and footing inventories. These service companies usually furnish a certificate attesting to the value of the physical inventory.

Assuming that the service company took the client company's inventory on the balance sheet date:

- How much reliance, if any, can the auditors place on the inventory certificate of outside specialists?
- What effect, if any, would the inventory certificate of outside specialists have upon the type of report the auditors would render? Discuss.
- What reference, if any, would the auditors make to the certificate of outside specialists in their audit report?

(AICPA, adapted)

- LO 12-6** 12-23. The observation of a client's physical inventory is a mandatory auditing procedure when possible for the auditors to carry out and when inventories are material.

- Why is the observation of physical inventory a mandatory auditing procedure? Explain.
- Under what circumstances is observation of physical inventory impossible?
- Why is the auditors' review of the client's control of inventory tags important during the observation of physical inventory? Explain.

- LO 12-1, 6** 12-24. During your observation of the November 30, 20X0, physical inventory of Newt Company, you note the following unusual items:

- Electric motors in finished goods storeroom not tagged. Upon inquiry, you are informed that the motors are on consignment to Newt Company.
- A cutting machine (one of Newt's principal products) in the receiving department, with a large "REWORK" tag attached.
- A crated cutting machine in the shipping department, addressed to a nearby U.S. naval base, with a Department of Defense "Material Inspection and Receiving Report" attached, dated November 30, 20X0, and signed by the Navy Source Inspector.
- An isolated storeroom with five types of dusty raw materials stored therein. Inventory tags are attached to all of the materials, and your test counts agree with the tags.

What additional procedures, if any, would you carry out for each of the above? Explain.

- LO 12-2, 6** 12-25. One of the problems faced by the auditors in their verification of inventory is the risk that slow-moving and obsolete items may be included in the goods on hand at the balance sheet date. In the event that such items are identified in the physical inventory, their carrying value should be written down to an estimated scrap value or other recoverable amount.

Prepare a list of the auditing procedures that the auditors should employ to determine whether slow-moving or obsolete items are included in the physical inventory.

- LO 12-1, 6** 12-26. Assume that you are auditing the financial statements of Wagner Pharma Co. for the year ending June 30, 20X1. Wagner has very large warehouses where it stores its numerous prescription drug products. The company tracks inventory with a radio frequency identification (RFID) system, which it uses to take inventory and control the movement of inventory items. It also uses drones to perform cycle tests of inventory quantities in its warehouses.

What are the implications of Wagner's procedures for the audit of inventories? Explain fully.

- LO 12-6** 12-27. Assume that you are auditing Hobart Wholesale Supply Co. and that you have decided to use data analytics to test the inventory. Specifically, you would like to identify (1) excess

and overvalued items in inventory (e.g., possibly obsolete, quantities well over needed) and (2) unusual transactions. From your discussions with management and your review of overall balances, you have determined that the company strives to maintain inventory levels at no more than 60 days' sales. Management also requires a minimum of 15 percent gross margin on all products. To perform your tests, assume you have the following four accounting data files.

1. Inventory Master File at Year-End

Item part no.
Item description
Quantity on hand
Quantity on order
Preferred vendor no.
Preferred vendor name
Average item cost

3. Sales File for the Year

Date shipped
Customer no.
Customer name
Sales order
Shipping order
Item part no.
Item description
Quantity sold
Sales price
Shipping cost

2. Purchases File for the Year

Date received
Item part no.
Item description
Number of items
Cost per item
Total cost
Vendor no.

4. Related Parties

Name
Relationship with company

- a. Describe how you can join (or relate) the files 1–3 so as to allow you to design tests of inventory using the data in all three of them.
- b. Describe two different data analytic tests that might be used to identify
 - (1) Excess quantities of inventory items.
 - (2) Unusual transactions.

LO 12-6 12–28. Grand Manufacturing Company employs standard costs in its cost accounting system. List the audit procedures that you would apply to ascertain that Grand's standard costs and related variance amounts are acceptable and have not distorted the financial statements. (Confine your audit procedures to those applicable to raw materials.)

Objective Questions

LO 12-2

12–29. **Multiple Choice Questions**

Select the best answer for each of the following and explain fully the reason for your selection.

- a. Which of the following is *least* likely to be among the auditors' objectives in the audit of inventories and cost of goods sold?
 - (1) Determine that the valuation of inventories and cost of goods sold is arrived at by appropriate methods.
 - (2) Determine the existence of inventories and the occurrence of transactions affecting cost of goods sold.
 - (3) Establish that the client includes only inventory on hand at year-end in inventory totals.
 - (4) Establish the completeness of inventories.
- b. The receiving department is *least* likely to be responsible for the:
 - (1) Determination of quantities of goods received.
 - (2) Detection of damaged or defective merchandise.
 - (3) Preparation of a shipping document.
 - (4) Transmittal of goods received to the store's department.

LO 12-3, 5

LO 12-3, 5

- c. The document issued by a common carrier acknowledging the receipt of goods and setting forth the provisions of the transportation agreement is the:
- (1) Bill of lading.
 - (2) Job time shipping.
 - (3) Production order.
 - (4) Production schedule.

LO 12-3, 5

- d. Which of the following should be included as a part of inventory costs of a manufacturing company?

	Direct Labor	Raw Materials	Factory Overhead
(1)	Yes	Yes	Yes
(2)	Yes	No	No
(3)	No	Yes	No
(4)	No	No	No

LO 12-3, 5

- e. The organization established by Congress to narrow the options in cost accounting that are available under generally accepted accounting principles is the:
- (1) Cost Accounting Standards Board.
 - (2) Financial Accounting Standards Board.
 - (3) Public Company Accounting Oversight Board.
 - (4) Securities and Exchange Commission.

LO 12-2, 4

- f. When a primary risk related to an audit is possible overstated inventory, the assertion most directly related is:
- (1) Existence.
 - (2) Completeness.
 - (3) Clarity.
 - (4) Presentation.

LO 12-5

- g. Instead of taking a physical inventory count on the balance sheet date, the client may take physical counts prior to the year-end if internal control is adequate and:
- (1) Well-kept records of perpetual inventory are maintained.
 - (2) Inventory is slow-moving.
 - (3) Computer error reports are generated for missing prenumbered inventory tickets.
 - (4) Obsolete inventory items are segregated and excluded.

LO 12-5, 6

- h. The auditor's analytical procedures will be facilitated if the client:
- (1) Uses a standard cost system that produces variance reports.
 - (2) Segregates obsolete inventory before the physical inventory count.
 - (3) Corrects material weaknesses in internal control before the beginning of the audit.
 - (4) Reduces inventory balances to the lower of cost or market.

LO 12-4, 5, 6

- i. When perpetual inventory records are maintained in quantities and in dollars, and internal control over inventory is weak, the auditor would probably:
- (1) Want the client to schedule the physical inventory count at the end of the year.
 - (2) Insist that the client perform physical counts of inventory items several times during the year.
 - (3) Increase the extent of tests for unrecorded liabilities at the end of the year.
 - (4) Have to disclaim an opinion on the income statement for that year.

LO 12-3, 6

- j. Which of the following is the best audit procedure for the discovery of damaged merchandise in a client's ending inventory?
- (1) Compare the physical quantities of slow-moving items with corresponding quantities in the prior year.
 - (2) Observe merchandise and raw materials during the client's physical inventory taking.
 - (3) Review the management's inventory representations letter for accuracy.
 - (4) Test overall fairness of inventory values by comparing the company's turnover ratio with the industry average.

LO 12-5, 6

k. McPherson Corp. does not make an annual physical count of year-end inventories, but instead makes weekly test counts on the basis of a statistical plan. During the year, Sara Mullins, CPA, observes such counts as she deems necessary and is able to satisfy herself as to the reliability of the client's procedures. In reporting on the results of her examination, Mullins:

- (1) Can issue an unqualified opinion without disclosing that she did not observe year-end inventories.
- (2) Should comment in the scope paragraph as to her inability to observe year-end inventories, but can nevertheless issue an unqualified opinion.
- (3) Is required, if the inventories are material, to disclaim an opinion on the financial statements taken as a whole.
- (4) Should, if the inventories are material, qualify her opinion.

LO 12-2, 6

l. The primary objective of a CPA's observation of a client's physical inventory count is to:

- (1) Discover whether a client has counted a particular inventory item or group of items.
- (2) Obtain direct knowledge that the inventory exists and has been properly counted.
- (3) Provide an appraisal of the quality of the merchandise on hand on the day of the physical count.
- (4) Allow the auditor to supervise the conduct of the count in order to obtain assurance that inventory quantities are reasonably accurate.

LO 12-6**12–30. Adapted AICPA Task-Based Simulation**

During the year 1 audit of Cellenting Co., the auditor performed various procedures relating to inventory. Match each of the following procedures with the description below:

Audit procedures

- Analytical procedure
- External confirmation
- Inquiry
- Inspection of records or documents
- Inspection of tangible assets
- Observation
- Recalculation
- Repurchase

(Each audit procedure may be used once, more than once, or not at all.)

Description of Audit Procedures Performed	Type of Audit Procedure
a. During the physical inventory count, the auditor asked the client to open various boxes of inventory items so she was able to assess the quality of the item.	
b. During a site visit to a construction site, the auditor determined that all employees were wearing proper safety equipment.	
c. The auditor asked the warehouse manager about whether certain inventory items were becoming obsolete.	
d. The auditor obtained a purchase order from the purchase order file and compared it to the authorized supplier list to determine that the related goods had been purchased from an approved supplier.	
e. The auditor calculated the accounts receivable turnover for the year.	
f. The auditor obtained a copy of the company's accounting manual and read the section on inventory to prepare for the physical inventory observation.	
g. The auditing firm's computer-assisted audit specialist obtained an electronic inventory file from the company and checked the accuracy of the extensions and footings.	

LO 12-4 12–31. **Adapted AICPA Task-Based Simulation**

For each of the independent situations described below select the appropriate inherent risk factor described and the effect of the inherent risk factor on the company's net income using the following:

Inherent Risk Factor	Effect on Net Income
(1) Complexity	(7) Overstatement
(2) Estimates	(8) Understatement
(3) Industry circumstances	(9) No effect
(4) Other external circumstances	
(5) Susceptibility of asset to theft	
(6) Volume	

Situation	Inherent Risk Factor	Effect of Inherent Risk Factor on Company's Net Income
a. Sales orders for a textbook distributor have increased 100% over the last year. Additionally, the company's inventory turnover has doubled since the previous year.		
b. Gold Miner Inc. has gold mines in a number of states. To hedge the price of its gold inventory, Gold Miner purchases gold futures contracts. The fair value of gold has declined significantly in the last few months.		
c. Metal Inc. supplies copper pipes to home builders. During year 1, copper prices doubled. At any given time, a significant amount of inventory is in transit or located at job sites.		
d. Joe's Computers provides three-year money-back warranties on all laptops. During year 1, warranty claims decreased significantly and the company has not reduced the warranty reserve.		
e. Global Co. imports most of its products from a foreign supplier. During year 1, a new technology made part of the Global Co. inventory obsolete.		

LO 12-5, 6 12–32. **Simulation**

Andy Watson, CPA, is a senior auditor on the audit of Carlson Inc. Andy is reviewing the results of analytical procedures related to inventory. For results (a), (b), and (c), select the explanation that is most likely to be consistent with the change described. Explanations may be used once, more than once, or not at all.

Explanation:

- (1) Inventory increased as of year-end.
 - (2) Debt outstanding increased.
 - (3) A larger percentage of sales occurred during the last month of 20X8, as compared to 20X7.
 - (4) Interest expense increased during 20X8 due to the acquisition of new debt.
 - (5) The percentage of tax included in the provision for income taxes for 20X8 is less than the percentage used in 20X7.
 - (6) Increases in costs of purchases were not completely passed on to customers through higher selling prices.
 - (7) Owners' equity increased due to retention of profits.
 - (8) Interest expense increased during 20X8.
 - (9) A significant amount of long-term debt became current at the end of 20X8.
- a. Inventory turnover (as measured by cost of goods sold/ending inventory) went from 7.95 in 20X7 to 10.52 in 20X8. Which of the explanations is consistent with the change in inventory turnover?
 - b. Net income increased in 20X8. Which of the explanations is most consistent with the changes in net income?

- c. The gross profit percentage (gross profit/revenue) changed from .166 in 20X7 to .154 in 20X8. Which of the explanations is consistent with the change in gross profit percentage?

Note: Section (d) is possible to work in a meaningful way only if you have the AICPA professional standards available—preferably in electronic form.

- d. Auditors ordinarily should observe the counting of inventories that are on hand. Use the professional standards to find this requirement and the related guidance. Provide the AICPA AU-C section that includes the guidance.

LO 12-1, 3, 4, 5, 6 12–33. **Simulation**

Auditors often observe the counting of their clients' inventories. You are working in the area of inventory with a new assistant on the audit of Jilco Inc. The assistant has a number of questions concerning inventory and the observation of inventory. Please reply "yes" or "no" to answer the following questions. Provide your rationale.

Statement

- a. With strong internal control, may Jilco Inc.'s inventory count be performed during the year rather than at year-end?
- b. Jilco Inc. has inventory at many locations. Do we need to be present for the count at all locations?
- c. Must I document all my test counts in the working papers?
- d. Am I correct that our observation of the counting of the inventory primarily addresses the existence of inventory, and not the completeness of the count?
- e. Is it correct that, because Jilco Inc. manufactures a product, direct labor and overhead ordinarily become a part of inventory costs?
- f. Should Jilco's inventory be valued at the lower of standard cost or market?
- g. Is it safe to assume that any inventory items present as "consigned in" should not be included in the client's inventory?
- h. When I take test counts of items, does this eliminate the need for Jilco Inc. personnel to count those items?
- i. Do I need to count all items in the inventory?
- j. At the completion of the count, should I leave Jilco Inc. personnel with a copy of all my inventory test counts to help assure inventory accuracy?

LO 12-2, 5, 6 12–34. **Multiple Choice Questions**

- a. An auditor most likely would make inquiries of production and sales personnel concerning possible obsolete inventory to address:
 - (1) Valuation.
 - (2) Rights.
 - (3) Existence.
 - (4) Presentation.
- b. An auditor selects items from the client's inventory listing and identifies the items in the warehouse. This procedure is most likely related to:
 - (1) Rights.
 - (2) Completeness.
 - (3) Existence.
 - (4) Valuation.
- c. An auditor concluded that no excessive costs for an idle plant were charged to inventory. This conclusion is most likely related to presentation and disclosure and:
 - (1) Valuation.
 - (2) Completeness.
 - (3) Existence.
 - (4) Rights.
- d. During the inventory count, an auditor selects items and determines that the proper description and quantity were recorded by the client. This procedure is most closely related to:
 - (1) Rights.
 - (2) Completeness.

(3) Existence.

(4) Valuation.

e. An auditor most likely would analyze inventory turnover rates to obtain evidence about:

(1) Existence.

(2) Rights.

(3) Presentation.

(4) Valuation.

LO 12-4, 5, 6

12-35. Document Review Simulation

This simulation, also available online, presents an Analytical Procedures/Risk Assessment Analysis document prepared by two members of your audit team—your responsibility is to evaluate various statements included in that document. Background financial and other information on Keystone is included in Appendix 6C of Chapter 6. *Parts 8–10 require information about accounting obtained in previous accounting and other courses. These topics are also addressed in subsequent chapters of this text (particularly Chapters 13 and 15).*

You are working on the audit of Keystone Computers & Networks Inc. (Keystone), a calendar year-end nonissuer. The two associates assigned to the engagement provided a document with a number of observations relating to analytical procedures/risk assessment for the audit of year 5. As the audit senior for this engagement, it is your responsibility to review the document and exhibits.

DOCUMENT

TO: Audit Senior
FROM: Audit Associates
RE: Analytical Procedures/Risk Assessment Analysis
DATE: January 7, year 6

We downloaded the year 4 audited and year 5 unaudited Keystone working trial balances into our macro (Exhibit 1). The program also calculated various ratios (Exhibit 2). Note that Exhibit 3 summarizes several of Keystone Company's key accounting policies.

Following are areas we believe include significant changes between years and our tentative conclusions:

- Overall, Keystone reports income decreasing from \$989,275 to \$229,877.
- The allowance for doubtful accounts increased by \$8,000 from year 4 to year 5. The company currently has \$104,000 in the allowance for doubtful accounts, and per the controller has \$31,701.54 in uncollectible accounts in receivables (Exhibit 4). The total of \$31,701.54 indicates that the allowance for doubtful accounts seems adequate as of year-end and that no adjusting entry is necessary. (Callout #1) See also the third bullet under suggested audit procedures.
- The current ratio decreased a bit, from 1.2 to 1.1. The input with the largest effect decreasing the current ratio is Cash—First National Bank. (Callout #2)
- The inventories, valued using the LIFO method, increased. To test proper use of the lower-of-cost-or-market rule relating to the LIFO method, we should perform tests to determine that inventory recorded values exceed current market values of the items. (Callout #3)

In addition, we suggest the following specific audit procedures:

- Relating to inventories, we should be aware of possible obsolete items; we should determine that all "slow-moving" items are valued at zero. (Callout #4)
- The president indicates that no inventory items (or proceeds upon sale) have been pledged (Exhibit 5). We should carefully inspect items for pledging status during the count of inventory. (Callout #5)
- Relating to doubtful accounts receivable (see second bullet above), we should be aware of potential other accounts that might need to be written off as of year-end and should test and analyze the client's aging of receivables. (Callout #6)
- Examine Board of Director approval of increased receivables from officers. Also, vouch the cash disbursement. (Callout #7)
- Although there were increases in fixed assets, the accumulated depreciation went up by a much larger percentage. It would seem that the client has a policy of making no depreciation entries related to acquisitions or disposals during the year and we should consider the propriety of this policy. (Callout #8)
- Vouch invoices in support of the change in leasehold improvements. (Callout #9)
- The capital stock and paid-in capital accounts did not change during the year. We should obtain evidence that no changes in shareholders occurred during the year. (Callout #10)

CALLOUT LIST #1*Choose an option below:*

- a. [Original text] indicates that the allowance for doubtful accounts seems adequate as of year-end and that no adjusting entry is necessary.
- b. [Delete text] (entire sentence)
- c. should be written off as of year-end with a debit to the allowance for doubtful accounts and a credit to accounts receivable and we should perform further procedures on the adequacy of the allowance for doubtful accounts.
- d. should be written off as of year-end with a debit to bad debt expense and a credit to the allowance for doubtful accounts and we should perform further procedures on the adequacy of the allowance for doubtful accounts.
- e. should be written off as of year-end with a debit to bad debt expense and a credit to accounts receivable and we should perform further procedures on the adequacy of the allowance for doubtful accounts.
- f. indicates that Keystone should never sell to the customers that compose that balance.

CALLOUT LIST #2*Choose an option below:*

- a. [Original text] Cash—First National Bank.
- b. Software development cost.
- c. Long-term debt.
- d. Accounts receivable—trade.
- e. Line of credit.

CALLOUT LIST #3*Choose an option below:*

- a. [Original text] exceed current market values of the items.
- b. equal the most recent purchase price of the items.
- c. equal or are less than current market prices of the items.
- d. are less than extended values of comparable items.
- e. exceed costs calculated using the FIFO method.

CALLOUT LIST #4*Choose an option below:*

- a. [Original text] we should determine that all “slow-moving” items are valued at zero.
- b. [Delete text] (replace semicolon with a period).
- c. we should calculate turnover ratios of inventory items.
- d. we must test every extension of quantity on hand times cost.
- e. we should combine our procedures here with those relating to leasehold improvements.
- f. the increase in software development cost is inconsistent with this change.

CALLOUT LIST #5*Choose an option below:*

- a. [Original text]. We should carefully inspect items for pledging status during the count of inventory.
- b. [Delete text]
- c. We should ask the president whether any inventory items are pledged.
- d. We should examine cash confirmations and debt agreements.
- e. We should emphasize subsequent event procedures.

CALLOUT LIST #6*Choose an option below:*

- a. [Original text] analyze the client's aging of receivables.
- b. calculate inventory turnover rates for items sold to accounts now past due.
- c. confirm all accounts that are not overdue as of year-end.
- d. vouch sales shortly before year-end.
- e. vouch sales shortly after year-end.

CALLOUT LIST #7*Choose an option below:*

- a. [Original text] vouch the cash disbursement.
- b. [Delete text]
- c. add to client representations letter that he guarantees repayment of the loan according to its terms.
- d. determine that the loan was approved by all shareholders.
- e. determine that the loan's stated rate exceeds the expected prime rate during the period of the loan.
- f. vouch the cash receipt.

CALLOUT LIST #8*Choose an option below:*

- a. [Original text] It would seem that the client has a policy of making no depreciation entries related to acquisitions or disposals during the year and we should consider the propriety of this policy.
- b. [Delete text]
- c. It is likely that the client extended the lives of assets and arrived at this amount of depreciation expense.
- d. The client must depreciate acquisitions items as per GAAP guidelines, ignoring salvage values, for estimated asset lives.
- e. We should inquire of the client as to details of this year's depreciation calculation and entry.
- f. We should pass on this as any difference is clearly immaterial and inconsequential.

CALLOUT LIST #9*Choose an option below:*

- a. [Original text] Vouch invoices in support of the change in leasehold improvements.
- b. [Delete text]
- c. Compare amortization period of leasehold improvements with accounts receivable aging.
- d. Consider the reasonableness of amortization of leasehold improvements during the year.
- e. Send confirmation requests on the leasehold improvements account total.

CALLOUT LIST #10*Choose an option below:*

- a. [Original text] no changes in shareholders occurred during the year.
- b. no dividends were paid during the year.
- c. no stock was issued or repurchased by Keystone during the year.
- d. all preferred stock issued during the year was properly included within the line of credit.
- e. cash disbursements for the year include no payments to shareholders.

EXHIBITS

1. Working Trial Balance
2. Ratios
3. CPA Firm Summary of Several Key Keystone Accounting Policies
4. E-mail to CFO from Controller
5. Memo from Audit Partner to Audit Files

EXHIBIT 1: Keystone Working Trial Balance

KEYSTONE COMPUTERS & NETWORKS INC. Year 5 Changes Spreadsheet For the Year Ended December 31, 20X5					
				Ref. No.	WTB-1
				Prep'd by	WL
				Date	1/10/X6
Acct. No.	Account Name	Year 4 Adjusted	Year 5 Unadjusted	Increase (Decrease)	Percentage Change
1000.10	Cash—General account	42,754	66,034	23,280	35.3%
1000.20	Cash—Special account	9,960	10,150	190	1.9%
1000.30	Cash in register	1,200	1,200	—	0.0%
1,000.40	Petty cash	50	50	—	0.0%
1050.10	Accounts receivable—trade	8,534,524	10,235,457	1,700,933	16.6%
1050.40	Accounts receivable—officers	57,643	84,670	27,027	31.9%
1050.90	Allowance for bad debts	(96,000)	(104,000)	(8,000)	7.7%
1100.10	Inventories	1,234,589	1,375,835	141,246	10.3%
1300.10	Prepaid expenses	156,900	176,456	19,556	11.1%
2050.10	Furniture & fixtures	300,980	344,900	43,920	12.7%
2050.30	Equipment	789,654	974,676	185,022	19.0%
2050.80	Leasehold improvements	98,900	91,230	(7,670)	−8.4%
2050.90	Accumulated depreciation	(250,987)	(404,560)	153,573	38.0%
2100.00	Software development cost		178,000	178,000	100.0%
2200.00	Intangible assets	1,000,000	800,000	(200,000)	−25.0%
3050.10	Accounts payable—trade	(1,349,839)	(1,429,033)	79,194	5.5%
3100.00	Capital lease oblig.—current	(43,200)	(45,675)	2,475	5.4%
3200.10	Accrued liabilities	(178,900)	(203,450)	24,550	12.1%
3300.30	Unearned service revenue		(42,300)	42,300	100.0%
3400.50	Line of credit	(6,612,550)	(8,632,105)	2,019,555	23.4%
4400.10	Capital lease oblig.—noncurr.	(456,700)	(423,680)	(33,020)	−7.8%
5050.10	Capital stock	(200,000)	(200,000)	—	0.0%
5100.10	Paid-in capital	(423,500)	(423,500)	—	0.0%
5700.10	Retained earnings	(1,626,203)	(2,615,478)	989,275	37.8%
5900.00	Dividends		415,000	415,000	100.0%
	Totals	989,275	229,877	(759,398)	−330.3%
6000.10	Sales of computers	(44,890,788)	(42,345,675)	(2,545,113)	−6.0%
6010.10	Software licenses	(248,900)	(236,700)	(12,200)	−5.2%
6020.10	Service revenue	(4,567,888)	(4,325,777)	(242,111)	−5.6%
6030.10	Consulting revenue	(46,751,990)	(45,677,899)	(1,074,091)	−2.4%
7020.10	Cost of sales—prod. & serv.	74,122,435	72,134,566	(1,987,869)	−2.8%
7070.10	Salaries—sales	3,167,889	2,765,677	(402,212)	−14.5%
7070.50	Payroll benefits—sales	913,456	857,368	(56,088)	−6.5%
7075.10	Advertising & promotion	1,200,786	1,567,889	367,103	23.4%
7080.10	Travel & entertainment	609,788	445,600	(164,188)	−36.8%
7080.30	Miscellaneous exp.—sales	334,890	278,656	(56,234)	−20.2%
7090.10	Operating salaries	4,878,900	4,544,860	(334,040)	−7.3%
7090.30	Administrative salaries	4,234,234	3,945,670	(288,564)	−7.3%
7090.50	Payroll benefits—admin.	1,812,344	1,734,565	(77,779)	−4.5%
7100.10	Rent	797,800	721,345	(76,455)	−10.6%

KEYSTONE COMPUTERS & NETWORKS INC.**Year 5 Changes Spreadsheet
For the Year Ended December 31, 20X5**

				Ref. No.	WTB-1
				Prep'd by	WL
				Date	1/10/X6
Acct. No.	Account Name	Year 4 Adjusted	Year 5 Unadjusted	Increase (Decrease)	Percentage Change
7140.10	Utilities	210,495	234,839	24,344	10.4%
7200.10	Insurance	356,890	378,677	21,787	5.8%
7260.30	Legal and accounting	457,577	485,767	28,190	5.8%
7320.10	Bad debt expense	234,500	256,678	22,178	8.6%
7410.10	Supplies	556,345	478,900	(77,445)	-16.2%
7600.10	Depreciation and amort.	334,565	367,867	33,302	9.1%
7650.10	Software development	289,100	345,645	56,545	16.4%
7700.10	Miscellaneous exp.—admin.	234,556	245,456	10,900	4.4%
7800.10	Interest expense	421,344	476,899	55,555	11.6%
7900.10	Current income taxes	256,765	80,100	(176,665)	-220.6%
7900.70	Deferred income taxes	45,632	9,150	(36,482)	-398.7%
9000.00	P & L Summary	989,275	229,877	(759,398)	-330.3%
	Total Balance Sheet	989,275	229,877	(759,398)	-330.3%
	Total Income Statement	(989,275)	(229,877)	759,398	-330.3%
	Out of balance	—	—	—	

EXHIBIT 2: Keystone Ratios**KEYSTONE COMPUTERS & NETWORKS INC.****Analytical Procedures Ratios
For the Years Ended December 31, Year 5**

				Ref. No.	Plan-1
				Prepared by	WL
				Date	1/10/Year 6
		Year 4	Year 5	Industry	
Current ratio		1.215	1.144	1.3	
Days sales in average accounts receivable		33.2	37.0	37.0	
Allowance for doubtful accounts/accounts receivable		1.1%	1.0%	—	
Bad debt expenses/net sales		0.2%	0.3%	—	
Total liabilities to net worth		2.7	3.5	2.9	
Return on total assets		8.3%	1.7%	9.0%	
Return on net worth		30.5%	7.5%	29.0%	
Return on net sales		1.0%	0.2%	2.3%	
Gross profit/net sales		23.2%	22.1%	24.0%	
Selling, operating, and admin. expense/net sales		21.4%	21.2%	23.9%	
Times interest earned		4.1	1.7	5.5	

EXHIBIT 3

CPA Firm Summary of several key Keystone accounting policies in addition to those included in the Overall Audit Strategy (Chapter 6):

- **Sales** are recorded when shipped. Shipment terms are often (about 2/3 of time) FOB shipping point, with the remainder FOB destination.
- **Bad debt expense** is estimated at a small percentage of credit sales based on experience. When an account is written off as uncollectible, the account receivable is credited, with a debit to allowance for doubtful accounts. Virtually all sales are for credit, payable within 30 days of the customer's receipt of the goods.
- **Inventory** is valued at LIFO.
- **Line of credit** is entirely a current liability.
- **Purchases** follow a similar pattern as above for sales.
- **Depreciation** for acquisitions and disposals is calculated to the nearest month (e.g., a June 25 acquisition would be depreciated for six months).

EXHIBIT 4

TO: CFO
 FROM: Controller
 RE: Accounts to Write Off
 DATE: December 15, Year 5

As per our discussion, here are the accounts that our Collections Chief has indicated are uncollectible as of year-end and should be written off:

Customer	Amount
Universal Design Partners	\$ 4,508.06
Nutri G	\$10,205.84
Environ Architectural Design	\$16,987.64
TOTAL	\$31,701.54

I have reviewed them and agree and will have my new assistant prepare a write-off entry as soon as these companies declare bankruptcy. Let me know if you need more information.

Controller

EXHIBIT 5

Memo from Audit Partner to Audit Files

November 17, year 4

TO: Files
 FROM: Partner of Keystone Audit

I discussed the year coming to a close for Keystone with the Keystone president. He pointed out that he was disappointed in the year's decrease in profits. Here is the information he provided:

- The Controller for the past 5 years resigned in July upon receiving a substantially higher paying job with DDF Corporation. He was replaced and it has been a rougher-than-hoped-for transition as the new controller has been overwhelmed by the many details of the position. However, the new controller seems to be "catching up with it."
- A decrease in all major types of sales will be reported this year—due in part to an unsuccessful advertising campaign, including a few advertisements on early morning (5 AM) political talk shows.
- No inventory items (or proceeds upon sale) have been pledged.
- Early in January of year 4, Keystone paid \$150,000 to be the sole distributor of the GMNE Mixer. The contract lasts for 10 years and may be renewed.

Problems

LO 12-3, 4, 5, 6

12-36. Described below are potential financial statement misstatements that are encountered by auditors.

- Inventory is understated because warehouse personnel overlooked several racks of parts in taking the physical inventory.
- Inventory is overstated because warehouse personnel included inventory items received subsequent to year-end while recording the purchase in the subsequent year to hide inventory shortages.
- Inventory is overstated because management instructed computer personnel to make changes in the file used to price inventories.

For each misstatement, identify whether the misstatement results from error or fraud, the type of controls that would serve to prevent or detect the misstatement, and the substantive procedures that might be used by the auditors to detect the misstatement. Organize your answer as follows:

Misstatement	Error or Fraud	Control	Substantive Procedure
a.			

LO 12-1, 3, 4, 5, 6

12-37. Howe Pharmaceutical Company produces a number of drugs that are regulated by various agencies, including, in the United States, the federal Food and Drug Administration (FDA). These agencies issue licenses that approve drugs for sale and establish specific regulations regarding production quality and inventory security, violations of which can result in fines or the suspension of product licenses. All the drugs are protected under patents filed in various jurisdictions, and Howe markets the drugs in the United States as well as in a number of other countries. The company faces significant competition from other pharmaceutical companies globally.

- Identify three business risks that are faced by Howe with respect to production processes and inventories.
- For each of the risks identified in part (a), state whether the business risk results in a current-period inherent risk of material misstatement of the financial statements (financial reporting risk). If the business risk results in a financial reporting risk, describe that risk in terms of the type of financial statement misstatement that could occur.
- Provide examples of how Howe's management might mitigate the risks (e.g., specific controls) identified in part (b) as financial reporting risks.
- For each risk identified in part (b) as a financial reporting risk, describe substantive auditing procedures that might be used by the auditors if management did not have controls to mitigate the risk.

LO 12-4, 6

12-38. Described below are potential financial statement misstatements that are encountered by auditors in the audit of inventory and cost of goods sold.

- Management of a chain of discount department stores systematically overstates inventory quantities at selected locations.
- Accounting personnel of a manufacturing company make computational errors that understate the production costs of certain inventory items.
- Management of a computer reseller overstates inventory value by failing to recognize the loss in value of certain inventory items that are obsolete.
- Production personnel for a high-tech manufacturing company include in inventory items that failed to meet essential quality standards.

For each misstatement, describe the substantive auditing procedures that may be used by auditors to detect the misstatement. Organize your answer as shown below:

Misstatement	Audit Procedures
a.	

- LO 12-3, 5, 6** 12-39. The following are typical questions that might appear on an internal control questionnaire for inventory:
1. Are written procedures prepared by the client for the taking of the physical inventory?
 2. Do the client's inventory-taking procedures include a requirement to identify damaged inventory items?
 3. Does the client maintain perpetual inventory records?
 - a. Describe the purpose of each of the above controls.
 - b. Describe the manner in which each of the above procedures might be tested.
 - c. Assuming that the operating effectiveness of each of the above procedures is found to be inadequate, describe how the auditors might alter their substantive procedures to compensate for the increased level of risk.
- LO 12-3, 5, 6** 12-40. You are involved in your CPA firm's first audit of Zorostris, a retailer of artwork, primarily paintings and photographs purchased from artists in Southeast Asia (particularly Vietnam, Cambodia, and Laos). Zorostris has stores in seven cities throughout the United States, Mexico, and Canada. Discuss difficulties you should anticipate in planning the observation of physical inventory on this engagement because of
- a. The different locations of stores.
 - b. The nature of artwork.
 - c. Assume that Zorostris's records indicate that it shipped goods on December 31 for a very major sale to a customer in Edmonton, Alberta, Canada.
 - (1) Because it was shipped as of December 31, does this represent a sale for the year ended on that date?
 - (2) What additional audit steps could be taken to determine that the sale is valid?
- LO 12-3, 5, 6** 12-41. You are an audit manager of the rapidly growing CPA firm of Raye and Coye. You have been placed in charge of three new audit clients, which have the following inventory features:
1. Canyon Cattle Co., which maintains 15,000 head of cattle on a 1,000-square-mile ranch, mostly unfenced, near the south rim of the Grand Canyon in Arizona.
 2. Rhoads Mfg. Co., which has raw materials inventories consisting principally of pig iron loaded on gondola freight cars on a siding at the company's plant.
 3. Strawser Company, which is in production around the clock on three shifts, and which cannot shut down production during the physical inventory.
- What problems do you anticipate in the observation of physical inventories of the three new clients, and how would you deal with the problems?
- LO 12-2, 6** 12-42. Smith is the partner in charge of the audit of Blue Distributing Corporation, a wholesaler that owns one warehouse containing 80 percent of its inventory. Smith is reviewing the working papers that were prepared to support the firm's opinion on Blue's financial statements, and Smith wants to be certain essential audit records are well documented. What substantive procedures should Smith expect to find in the working papers to document management's assertion about completeness as it relates to the inventory quantities at the end of the year?
- (AICPA, adapted)

In-Class Team Case

LO 12-1, 2, 6



- 12-43. Hovington, CPA, knows that while audit objectives relating to inventories may be stated in terms of the assertions as presented in this chapter, they also may be subdivided and stated more specifically. He has chosen to do so and has prepared the second column of the following table.

Financial Statement Assertion	Specific Audit Objective	Audit Procedure
	1. The entity has legal title to inventories.	
	2. Recorded inventory quantities include all products on hand.	
	3. Inventories are reduced, when appropriate, to replacement cost or net realizable value.	
	4. Cost of inventories is properly calculated.	
	5. The major categories of inventories and their basis of valuation are adequately reported in the financial statements.	

Assume that Hovington's client, a retail department store, does no production. For each specific inventory audit objective listed above, select the most closely related financial statement assertion and the most appropriate audit procedure from the following:

Financial Statement Assertion	Audit Procedure
A. Completeness and cutoff	F. Examine current vendors' price lists.
B. Existence or occurrence	G. Review drafts of the financial statements.
C. Presentation and disclosure	H. Select a sample of items during the physical inventory count and determine that they have been included on count sheets.
D. Rights and obligations	I. Select a sample of recorded items and examine supporting vendors' invoices and contracts.
E. Valuation and accuracy	J. Select a sample of recorded items on count sheets during the physical inventory count and determine that items are on hand.
	K. Test reasonableness of direct labor rates.

Financial statement assertions and audit procedures may be selected once, more than once, or not at all.

Ethics Case

LO 12-1, 5, 6



- 12-44. You have been with Zaird & Associates for approximately three months and are completing your work on the BizCaz audit. BizCaz produces pullover knit shirts to address the business casual market for both men and women. Although your experience has been limited, an unexpected staff resignation has resulted in your working directly with the engagement's in-charge senior on inventory. This has been a learning experience for you because you have helped perform various tests of controls, which may be summarized as indicating that internal control over inventory (including the perpetual records) seems strong. It is your impression that those tests resulted in a decrease in substantive procedures, thereby allowing a particularly efficient audit.

At the beginning of the audit, Jan Wheeler, the in-charge senior, told you that the management team of BizCaz has always been helpful and friendly. Throughout the audit, you have found the situation to be as good as described. In fact, BizCaz allows each auditor to purchase up to three shirts at a particularly attractive price of \$12 per shirt, the cost for which employees may purchase shirts. The shirts have a market value of around \$50, although the direct labor and material costs of each shirt are only \$10.

Near the conclusion of the audit, after you and the other three staff members paid the controller and told him your sizes, he walked to the warehouse, removed 12 shirts from the appropriate piles, and brought them out. That evening you gave the situation some thought. On the one hand, the company didn't lose any money on your purchase of the shirts—but on the other hand, you would never have been able to purchase such high-quality clothes for such a low price.

1. Is it acceptable to purchase these shirts from the audit client in this manner?
2. Discuss the effect of any information presented in the case on the adequacy of the audit.

Research and Discussion Case

LO 12-1, 6



- 12-45. Western Trading Company is a sole proprietorship engaged in the grain brokerage business. On December 31, 20X0, the entire grain inventory of the company was stored in outside bonded warehouses. The company's procedure of pricing inventories in these warehouses includes comparing the actual cost of each commodity in inventory with the market price as reported for transactions on the commodity exchanges at December 31. A write-down is made on commodities in which cost is in excess of market. During the course of the 20X0 audit, the auditors verified the company's computations. In addition to this, they compared the book value of the inventory with market prices at February 15, 20X1, the last day of fieldwork. The auditors noted that the market prices of several of the commodities had declined sharply subsequent to year-end, until their market price was significantly below the commodities' book values.

The inventory was repriced by the auditors on the basis of the new market prices, and the book value of the inventory was found to be in excess of market value on February 15 by approximately \$21,000. The auditors proposed that the inventories be written down by \$17,000 to this new market value, net of gains on the subsequent sales. The management protested this suggestion, stating that in their opinion the market decline was only temporary and that prices would recover in the near future. They refused to allow the write-down to be made. Accordingly, the auditors qualified their audit opinion for a departure from generally accepted accounting principles.

- a. Were the auditors justified in issuing a qualified opinion in this situation? Discuss fully, including alternative courses of action.
- b. State your opinion as to the course of action that was appropriate in this situation.

Property, Plant, and Equipment: Depreciation and Depletion

LO 13-1

Describe the nature of property, plant, and equipment and depreciation.

The term *property, plant, and equipment* includes all tangible assets with a service life of more than one year that are used in the operation of the business and are not acquired for the purpose of resale. Three major subgroups of such assets are generally recognized:

1. *Land*, such as property used in the operation of the business, has the significant characteristic of not being subject to depreciation.
2. *Buildings, machinery, equipment, and land improvements*, such as fences and parking lots, have limited service lives and are subject to depreciation.
3. *Natural resources* (wasting assets), such as oil wells, coal mines, and tracts of timber, are subject to depletion as the natural resources are extracted or removed.

Acquisitions and disposals of property, plant, and equipment are usually large in dollar amount, but concentrated in only a few transactions. Individual items of plant and equipment may remain unchanged in the accounts for many years.

Property, Plant, and Equipment

The Auditors' Objectives in Auditing Property, Plant, and Equipment

LO 13-2

Identify the auditors' objectives in the audit of property, plant, and equipment.

The auditors' *objectives* in the audit of property, plant, and equipment are to

1. Use the understanding of the client and its environment to consider *inherent risks*, including fraud risks, related to property, plant, and equipment.
2. Obtain an understanding of *internal control* over property, plant, and equipment.
3. Assess the risks of material misstatement and design tests of controls and substantive procedures that
 - a. Substantiate the *existence* of property, plant, and equipment and the occurrence of the related transactions.
 - b. Establish the *completeness* of recorded property, plant, and equipment.
 - c. Verify the *cutoff* of transactions affecting property, plant, and equipment.
 - d. Determine that the client has *rights* to the recorded property, plant, and equipment.
 - e. Establish the proper *valuation* or *allocation* of property, plant, and equipment and the *accuracy* of transactions affecting property, plant, and equipment.
 - f. Determine that the *presentation* and *disclosure* of information about property, plant, and equipment are appropriate, including disclosure of depreciation methods.

In conjunction with the audit of property, plant, and equipment, the auditors also obtain evidence about the related accounts of depreciation expense, accumulated depreciation, and repairs and maintenance expense.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 13-1** Describe the nature of property, plant, and equipment and depreciation.
- LO 13-2** Identify the auditors' objectives in the audit of property, plant, and equipment.
- LO 13-3** Explain the fundamental controls over property, plant, and equipment.
- LO 13-4** Use the understanding of the client and its environment to consider inherent risks (including fraud risks) related to property, plant, and equipment.
- LO 13-5** Obtain an understanding of internal control over property, plant, and equipment.
- LO 13-6** Assess the risks of material misstatement of property, plant, and equipment and design further audit procedures, including tests of controls and substantive procedures, to address the risks.
- LO 13-7** Explain the auditors' approach to the audit of depreciation.
- LO 13-8** Describe how the auditors design audit procedures to audit intangible assets.

Contrast with Audit of Current Assets

In many companies, the investment in plant and equipment amounts to 50 percent or more of the total assets. However, the audit work required to verify these properties is usually a much smaller proportion of the total audit time spent on the engagement. The verification of plant and equipment is facilitated by several factors not applicable to audit work on current assets.

First, a typical unit of property or equipment has a high dollar value, and relatively few transactions may lie behind a large balance sheet amount. Second, there is usually relatively little change in the property accounts from year to year. The Land account often remains unchanged for a long span of years. The durable nature of buildings and equipment also tends to hold accounting activity to a minimum for these accounts. By way of contrast, such current assets as accounts receivable and inventory may have a complete turnover several times a year.

A third point of contrast between the audit of plant assets and the audit of current assets is the significance of the year-end cutoff of transactions on net income. For current assets, the year-end cutoff is a critical issue; for plant assets, it is of lesser importance. For example, in our discussion of inventories in Chapter 12, we emphasized the importance of an accurate year-end cutoff of the transactions for purchases and sales of merchandise. An error in the cutoff of a \$50,000 purchase or sales transaction may cause a \$50,000 error in the year's pretax net income. The possibility of such errors is substantial because a large volume of merchandise transactions is normal at year-end. For plant assets, on the other hand, a year-end cutoff error in recording an acquisition or retirement ordinarily will not affect net income for the year. Moreover, for many companies, there may be no transactions in plant assets occurring at year-end. Of course, a cutoff error relating to acquisition or retirement of plant assets could cause slight inaccuracies in depreciation or in the timing of gains or losses on disposals. The problem of year-end cutoff for plant assets, however, should be considered of less importance in contrast to the audit of current assets.

Internal Control over Plant and Equipment

The amounts invested in plant and equipment represent a large portion of the total assets of many industrial concerns. Maintenance, rearrangement, and depreciation of these assets are major expenses in the income statement. The total expenditures for the assets and related expenses make strong internal control essential to the preparation of reliable financial statements. Errors in measurement of income may be material if assets are scrapped without their cost being removed from the accounts, or if the distinction between capital and revenue expenditures is not maintained consistently. The losses that inevitably arise from uncontrolled methods of acquiring, maintaining, and retiring plant and equipment are often greater than the losses from fraud in cash handling.

In large enterprises, the auditors may expect to find an annual plant budget used to forecast and control acquisitions and retirements of plant and equipment. Many small companies also forecast expenditures for plant assets. Successful utilization of a plant budget presupposes the existence of reliable and detailed accounting records for plant and equipment. A detailed knowledge of the kinds, quantities, and condition of existing equipment is an essential basis for intelligent forecasting of the need for replacements and additions to the plant.

Other key controls applicable to plant and equipment are as follows:

1. A subsidiary ledger consisting of a separate record for each unit of property. An adequate plant and equipment ledger facilitates the auditors' work in analyzing additions and retirements, in verifying the depreciation provision and maintenance expenses, and in comparing authorizations with actual expenditures.
2. A system of authorizations requiring advance executive approval of all plant and equipment acquisitions, whether by purchase, lease, or construction. Serially numbered capital **work orders** are a convenient means of recording authorizations.
3. A required review of construction and lease contracts by competent personnel to ensure that the accounting is in accordance with the appropriate accounting framework.
4. **Management review controls** that involve prompt identification of unusual items and relationships that might be indicative of misstatements, and variances between authorized expenditures and actual costs.

LO 13-3

Explain the fundamental controls over property, plant, and equipment.



Illustrative Case

Use of Drones for Asset Inspection

Increasingly companies are using drones to physically inspect assets that are difficult to access. As indicated in Chapter 12, drones are used to assist

in the taking of physical inventories. They may also be used to inspect remote assets, equipment, plants, and buildings for maintenance problems.

5. An authoritative written statement of company policy distinguishing between **capital expenditures** and **revenue expenditures**. A dollar minimum ordinarily will be established for capitalization; any expenditures of a lesser amount automatically are classified as charges against current revenue.
6. A policy requiring all purchases of plant and equipment to be handled through the purchasing department and subjected to standard routines for receiving, inspection, and payment.
7. Periodic physical inventories designed to verify the existence, location, and condition of all property listed in the accounts and to disclose the existence of any unrecorded units. When the assets are mobile and of high value, a radio frequency identification or global positioning system may be used to track the movement of the assets and help prevent theft.
8. A system of retirement procedures, including serially numbered *retirement work orders* (below), stating reasons for retirement and bearing appropriate approvals.
9. Policies and procedures for the periodic evaluation of property, plant, and equipment for impairment by competent personnel using appropriate models and assumptions and relevant and reliable data.

Audit Documentation

The key audit working paper for property, plant, and equipment is a summary analysis such as that illustrated in Figure 13.1. This working paper follows the approach we have previously described of *emphasizing changes during the year under audit*. The working paper shows the beginning balances for the various types of plant assets; these amounts are the ending balances shown in the prior year's working papers. Next, the working paper shows the additions and retirements during the year. These are the transactions upon which the auditors' attention will be focused. A final column shows the ending balances that must equal the beginning balances plus the additions and minus the retirements. A similar set of four columns is used to summarize the changes in the accounts for accumulated depreciation.

Perfect Manufacturing Co. Retirement Work Order		394837
Department: Milling	Date: <u>October 10, 20X1</u>	
Property ID No. 75666	Description Drill Press	
Disposition: <u>Scrapped</u> 		
Approved By: <u>Austine Webb</u>		

FIGURE 13.1 Analysis of Property, Plant, and Equipment

THE MANDVILLE CORPORATION										
Summary of Property, Plant, and Equipment and Accumulated Depreciation										
December 31, 20X2										
Account Number	Description	Assets			Method	Rate	Accumulated Depreciation			
		Balance 12/31/X1	Additions	Retirements			Balance 12/31/X1	Provision	Retirements	Balance 12/31/X2
151	Land	500,000	Y 151,000							
152-3	Land Improv.	135,000	Y 10,000		S.L.	5%	13,500	Y 7,000		20,500 ✓
154-5	Buildings	4,500,000	Y 495,000		S.L.	3%	292,000	Y 142,420		434,420 ✓
156-7	Equipment	800,000	Y 110,000	60,000	S.L.	10%	235,000	Y 70,600	50,600	255,000 ✓
TOTALS		5,935,000	766,000	60,000			540,500	220,020	50,600	709,920
			K-1-1					K-1-2	K-1-1-1	K

Y Agreed to prior year work papers.

✓ Footed plant and equipment subsidiary ledger cards. No exceptions.

Conclusion:

As a result of our audit procedures for property, plant, and equipment and related depreciation, it is our opinion that the 12/31/X2 balances are fairly stated.

VMH

1/17/X3

CMW

1/25/X3

Among the other audit working papers for property, plant, and equipment are analyses of the year's additions and retirements, analyses of repairs and maintenance expense accounts, and tests of depreciation. The analyses of plant additions and retirements and the tests of depreciation are cross-indexed to the summary analysis, as illustrated in Figure 13.1. In the audit of larger companies, it is common practice for the client to prepare for the auditors both a listing of the year's additions and a schedule of the year's disposals. In addition, the auditors document internal controls and risk assessments for property, plant, and equipment.

Initial Audits and Repeat Engagements

The auditing procedures listed in subsequent pages are applicable to repeat engagements and therefore concern only transactions of the current year. In the auditors' first audit of a new client that has changed auditors, a review of the predecessor auditor's audit documentation may provide substantial audit evidence about opening balances and consistency of accounting principles. However, the nature, timing, and extent of audit work performed and conclusions reached are the responsibility of the successor auditor. Nonetheless, if previous audits were performed by a reputable CPA firm, that firm's work will be extremely helpful to the successor auditor.

In a first audit of a company that has *not* previously been audited, or one in which access to a predecessor's audit work is not available, the ideal approach is a complete historical analysis of the property accounts. By thorough review of all major charges and credits to the property accounts since their inception, the auditors can establish the validity of the beginning balances of property, plant, and equipment and accumulated depreciation.

If the client has been in business for many years, the review of transactions in earlier years necessarily should be performed on a test basis in order to stay within reasonable time limits. However, the importance of an analysis of transactions of prior years deserves emphasis. Only by this approach can the auditors be in a sound position to express an opinion as to the propriety of the current period's depreciation. If repair and maintenance expenses have been capitalized, or asset additions have been recorded as operating expenses, or retirements of property have gone unrecorded, the depreciation expense will be misstated regardless of the care taken in the selection of depreciation rates. The auditors should make clear to the client that the initial examination of plant and equipment requires procedures that need not be duplicated in subsequent engagements.

Audit of Property, Plant, and Equipment

The following steps indicate the general pattern of work performed by the auditors in the verification of property, plant, and equipment. The procedures for depreciation are covered in a separate program later in this chapter. Selection of the most appropriate procedures for a particular audit will be guided by the nature of the controls that have been implemented and by the results of the auditors' risk assessments.

- A. Use the understanding of the client and its environment to consider inherent risks, including fraud risks, related to property, plant, and equipment.
- B. Obtain an understanding of internal control over property, plant, and equipment.
- C. Assess the risks of material misstatement and design further audit procedures.
- D. Perform further audit procedures—tests of controls.
 1. Test controls over the purchase and retirement of property, plant, and equipment.
 2. Test **management review controls**.
 3. If necessary, revise the risks of material misstatement based on the results of tests of controls.

E. Perform further audit procedures—substantive procedures for property, plant, and equipment.

1. Obtain a summary analysis of changes in property owned and reconcile to ledgers.
2. Vouch additions to property, plant, and equipment during the year.
3. Make a physical inspection of major acquisitions of plant and equipment.
4. Analyze repair and maintenance expense accounts.
5. Investigate the status of property, plant, and equipment not in current use.
6. Test the client's provision for depreciation.
7. Evaluate and test the accounting for impairments of property, plant, and equipment.
8. Investigate retirements of property, plant, and equipment during the year.
9. Examine evidence of legal ownership of property, plant, and equipment.
10. Review rental revenue from land, buildings, and equipment owned by the client but leased to others.
11. Evaluate and test the accounting for lease agreements on property, plant, and equipment.
12. Perform analytical procedures or data analytics for property, plant, and equipment.
13. Evaluate financial statement presentation and disclosure for plant assets and for related revenue and expenses.

These substantive audit procedures are summarized in Figure 13.2 along with the primary audit objectives.

LO 13-4

Use the understanding of the client and its environment to consider inherent risks (including fraud risks) related to property, plant, and equipment.

A. Use the Understanding of the Client and Its Environment to Consider Inherent Risks, Including Fraud Risks, Related to Property, Plant, and Equipment.

After they have obtained an understanding of the client and its environment, the auditors will identify and assess inherent risks related to property, plant, and equipment.

If any of the inherent risks identified by the auditors involve the possibility of fraud, they will make sure that they understand the programs and controls established by management to control the risk. They will also determine that the controls have been implemented. Finally, the auditors will design an appropriate response to the risk.

B. Obtain an Understanding of Internal Control over Property, Plant, and Equipment.

In obtaining an understanding of internal control over property, plant, and equipment, the auditors may utilize a written description, flowcharts, or an internal control questionnaire.



FIGURE 13.2
Objectives of Major
Substantive Procedures
for Property, Plant,
and Equipment and
Depreciation

Substantive Procedures	Primary Audit Objectives
Obtain a summary analysis of changes in property owned and reconcile to ledgers.	<i>Valuation</i>
Vouch additions during year.	<i>Existence, occurrence, and rights</i>
Make physical inspection of major acquisitions.	<i>Valuation or allocation</i>
	<i>Accuracy</i>
	<i>Cutoff</i>
Analyze repair and maintenance expense accounts.	<i>Valuation or allocation</i>
Investigate the status of property not in current use.	<i>Valuation or allocation</i>
	<i>Presentation and disclosure</i>
Test the client's provision for depreciation.	<i>Valuation and allocation</i>
Evaluate and test accounting for impairments.	
Investigate retirements of property during the year.	<i>Existence, occurrence, and rights</i>
Examine evidence of legal ownership.	
Review rental revenue.	
Evaluate and test accounting for lease agreements.	<i>Existence and rights</i>
Perform analytical procedures or data analytics.	<i>Completeness</i>
	<i>Valuation or allocation</i>
Evaluate financial statement presentation and disclosure.	<i>Presentation and disclosure</i>

LO 13-5

Obtain an understanding of internal control over property, plant, and equipment.

The following are typical of the questions included in a questionnaire: Are plant ledgers regularly reconciled with general ledger control accounts? Are periodic physical inventories of plant assets compared with the plant ledgers? Are variances between plant budgets and actual expenditures for plant assets subject to review and approval of executives? Does the sale, transfer, or dismantling of equipment require written executive approval on a serially numbered retirement work order? Is there a written policy for distinguishing between capital expenditures and revenue expenditures?

After preparing a description of internal control, the auditors will determine whether the controls as described to them have been *implemented*. To confirm their understanding of these policies and procedures, they will observe whether there is an appropriate segregation of duties over the acquisition of plant assets and inquire as to who performed various functions throughout the period. They will also inspect the subsidiary ledger of property, plant, and equipment; the serially numbered work orders; and the plant and equipment budget and examine evidence of the follow-up on variances from the budget. These procedures may provide the auditors with sufficient evidence to assess control risk for certain financial statement assertions about property, plant, and equipment as being at less than the maximum.

LO 13-6

Assess the risks of material misstatement of property, plant, and equipment and design further audit procedures, including tests of controls and substantive procedures, to address the risks.

C. Assess the Risks of Material Misstatement and Design Further Audit Procedures.

After considering the information about the client and its environment, including internal control over property, plant, and equipment, the auditors identify and assess the risks of material misstatement, identify relevant assertions, and design appropriate further audit procedures in response. To make these assessments, the auditors should consider the relationships between specific misstatements and controls. Figure 13.3 provides examples of potential misstatements of property, plant, and equipment and weaknesses in internal control that would make them more likely to occur.

The auditors' assessments of the risks of material misstatement (inherent and control risks) are used to design further audit procedures, including tests of controls and substantive procedures. The further audit procedures should include tests of controls when the auditors' assessments of control risk assume that controls are operating effectively, but, in regard to their understanding of the client's internal control, the auditors have not obtained sufficient evidence that controls are operating effectively.

Some of the risks identified by the auditors may be considered to be significant risks that require special audit consideration, as presented in Chapter 6.

FIGURE 13.3 Potential Misstatements—Investments in Property, Plant, and Equipment

Description of Misstatement	Examples	Internal Control Weaknesses or Factors That Increase the Risk of the Misstatement
Misstatement of acquisitions of property, plant, and equipment	Fraud: - Expenditures for repairs and maintenance expenses recorded as property, plant, and equipment acquisitions to overstate income Error: - Purchases of equipment erroneously reported in maintenance and repairs expense account	- Undue pressure to meet earnings targets - Inadequate accounting manual; incompetent accounting personnel
Failure to record retirements of property, plant, and equipment	Error: An asset that has been replaced is discarded due to its lack of value, without an accounting entry	Inadequate accounting policies, e.g., failure to use retirement work orders
Improper reporting of unusual transactions	Error: A "gain" recorded on an exchange of nonmonetary assets that lacks commercial substance	Inadequate accounting manual; incompetent accounting personnel

D. Perform Further Audit Procedures—Tests of Controls.

1. Test Controls over the Purchase and Retirement of Property, Plant, and Equipment.

Tests directed toward the effectiveness of controls are used to evaluate the client's internal control and determine whether the auditors can justify their planned assessed levels of control risk for the assertions about property, plant, and equipment accounts. Certain tests of controls are performed as the auditors obtain an understanding of the client's internal control; these tests were described in our discussion of that process. Additional tests of controls, for example, might include selecting a sample of purchases of plant and equipment to test the controls related to authorization, receipt, and proper recording of the transactions. A sample of recorded retirements also may be tested for proper authorization and supporting retirement work orders. These tests often will be combined with the substantive tests of additions and retirements described in the following sections.

2. Test Management Review Controls.

The auditors will evaluate **management review controls** by considering whether the controls would be effective at detecting and correcting misstatements in relevant assertions. If the design of controls is considered to be effective, the auditors may test the controls by inspecting documentation of their performance, including the manner in which unusual items or relationships were identified, investigated, and resolved.

3. If Necessary, Revise the Risks of Material Misstatement Based on the Results of Tests of Controls.

If the tests of controls reveal that the operating effectiveness of controls over property, plant, and equipment is not as anticipated, the auditors will have to reassess the risks of material misstatement. This will allow them to determine the substantive procedures that should be performed.

E. Perform Further Audit Procedures—Substantive Procedures for Property, Plant, and Equipment.

1. Obtain a Summary Analysis of Changes in Property Owned and Reconcile to Ledgers.

The auditors may verify the beginning balances of plant and equipment assets by reference to the prior year's audit working papers. In addition to beginning balances, the summary analysis will show the additions and retirements of plant and equipment during the year under audit. As the audit progresses, the auditors will examine a sample of these additions and retirements. The detailed working papers showing this verification will support and be cross-indexed to the summary analysis worksheet.

Before making a detailed analysis of changes in property accounts during the year, the auditors will want to be sure that the amounts in the subsidiary ledgers agree in total with the balances in the controlling accounts. Reconciliation of the subsidiary ledgers with the controlling accounts can be performed very quickly with the use of generalized audit software.

2. Vouch Additions to Property, Plant, and Equipment during the Year.

The vouching of additions to the property, plant, and equipment accounts during the period under audit is one of the most important substantive tests. The extent of the vouching is dependent upon the auditors' assessment of control risk for the existence and valuation of plant and equipment. The vouching process utilizes a working paper analysis of the general ledger control accounts and includes the tracing of entries through the journals to original documents, such as contracts, deeds, construction work orders, invoices, canceled checks, and authorization by appropriate individuals.

The specific steps to be taken in investigating the year's additions usually will include the following:

- a. On a test basis, vouch purchases of property, plant, and equipment to invoices, deeds, contracts, or other supporting documents. Recompute extensions, footings, and treatment of discounts. Make certain repairs and maintenance expenses (or other expenses) were not improperly capitalized.

Primary Audit Objective:	
Valuation	☒

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Rights	☒
Valuation	☒
Accuracy	☒
Cutoff	☒

- b. Investigate all instances in which the actual cost of acquisitions substantially exceeded authorized amounts. Determine whether such excess expenditures were analyzed and approved by appropriate officials.
- c. Investigate fully any debits to property, plant, and equipment accounts not arising from acquisition of physical assets.
- d. Determine that the total cost of any plant and equipment assets purchased on the installment plan is reflected in the asset accounts and that the unpaid installments are set up as liabilities.
- e. Review changes during the year in construction in progress and examine supporting work orders, both incomplete and closed.
- f. Trace transfers from the Construction in Progress account to the property accounts, observing propriety of classification. Determine that all completed items have been transferred out of the account.

The accounting for plant assets acquired in a nonmonetary exchange is specified by FASB ASC 845-10-30. Generally, these assets are recorded at fair value, unless fair value is not determinable, the exchange is to facilitate sales to customers, or the exchange lacks commercial substance.

Assets constructed by a company for its own use should be recorded at the cost of direct materials, direct labor, and applicable overhead cost. However, auditors may apply the additional test of comparing the total cost of self-constructed equipment with bids or estimated purchase prices for similar equipment from outside suppliers; excess costs of self-constructed assets should be expensed in the period that construction is completed.

Related Party Transactions

Assets acquired from affiliated corporations, from promoters or stockholders, or by any other type of related party transaction not involving arm's-length bargaining between buyer and seller have sometimes been recorded at inflated amounts. The auditors should inquire into the methods by which the sales price was determined, the cost of the property to the vendor, length of ownership by the vendor, and any other available evidence that might indicate an arbitrarily determined valuation. Material related party transactions must be disclosed in the notes to the financial statements.

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Rights	☒
Valuation	☒
Accuracy	☒
Cutoff	☒

3. Make a Physical Inspection of Major Acquisitions of Plant and Equipment.

The auditors usually make a physical inspection of major units of plant and equipment acquired during the year under audit. This step is helpful in maintaining a good working knowledge of the client's operations and also in interpreting the accounting entries for both additions and retirements.

The audit procedure of physical inspection may flow in either direction between the plant assets and the records of plant assets. By tracing items in the plant ledger to the physical assets, the auditors prove that the assets shown in the accounting records *actually* exist and are in current use. The alternative testing procedure is to inspect selected assets in the plant and trace these assets to the detailed records. This test provides evidence that existing assets are recorded (completeness).

The physical inspection of plant assets may be limited to major units acquired during the year or may be extended to include tests of older equipment as well. In a few situations (especially when the risk of material misstatement is very high), the auditors may conclude that the taking of a complete physical inventory is needed. Bear in mind, however, that a complete physical inventory of plant and equipment is a rare event. If such an inventory is required, the auditors' role is to *observe* the physical inventory. Where assets are maintained in difficult-to-access areas, the auditors may decide to use drones to assist in observing and inspecting the assets.

Let us consider an example of a situation in which the auditors might conclude that a complete physical inventory of equipment is needed. Assume that a client is engaged in commercial construction work and that the client owns and operates a great many units

of costly mobile equipment. Such equipment may often be scrapped or sold upon the authorization of a field supervisor. Under these circumstances, the auditors might regard a complete physical inventory of plant and equipment as essential. Similarly, in the audit of clients owning a large number of automobiles and trucks, the auditors may insist upon observing a physical count, as well as examining legal title.

Some large companies, as part of their internal control, perform occasional physical inventories of plant and equipment at certain locations or in selected departments. The *observation* of these limited counts is often carried out by the client's internal auditing staff rather than by the independent auditors.

Primary Audit Objective:	
Valuation	☒

4. Analyze Repair and Maintenance Expense Accounts.

The auditors' principal objective in analyzing repair and maintenance expense accounts is to discover expenditures for fixed assets or other items that should have been capitalized. In performing this procedure, the auditors should be aware of the company's policy regarding the minimum expenditure to be capitalized. For example, company policy may prescribe that no expenditure for less than \$5,000 shall be capitalized regardless of the service life of the item purchased. In such cases, the auditors will analyze the repair and maintenance accounts with a view toward determining the consistency of application of this policy as well as compliance with generally accepted accounting principles. To determine that the accounts contain only proper repair and maintenance charges, the auditors will trace the larger expenditures to written authorizations for the transaction. The auditors may use data analytics software to identify transactions for evaluation. As an example, the auditors may use data analytics to identify large expenditures with descriptions that indicate a capital expenditure rather than an expense. The accuracy of the client's accounting for the expenditures may be verified by reference to vendors' invoices, material requisitions, and labor time records.

One useful means of identifying capital expenditures that have been included in the repair and maintenance accounts is to obtain or prepare an analysis of the monthly amounts of expense with corresponding amounts listed for the preceding year. Any significant variations from month to month or between corresponding months of the two years should be fully investigated. If maintenance expense is classified by the departments serviced, the variations are especially noticeable.

Primary Audit Objectives:	
Valuation	☒
Presentation	☒

5. Investigate the Status of Property, Plant, and Equipment Not in Current Use.

Land, buildings, and equipment not in current use should be investigated thoroughly to determine the prospects for their future use in operations. Plant assets that are temporarily idle need not be reclassified, and depreciation may be continued at normal rates. On the other hand, idle equipment that has been dismantled, or that for any reason appears unsuitable for future operating use, should be written down to an estimated realizable value and excluded from the plant and equipment classification. In the case of standby equipment and other property not needed at present or prospective levels of operation, the auditors should consider whether the carrying value is recoverable through future use in operations.

Primary Audit Objective:	
Valuation	☒

6. Test the Client's Provision for Depreciation.

See the separate *depreciation* program following this audit program.

Primary Audit Objective:	
Valuation	☒

7. Evaluate and Test the Accounting for Impairments of Property, Plant, and Equipment.

Accounting standards require that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. In these circumstances, if the sum of the expected undiscounted future cash flows from the asset is less than its carrying amount, an impairment loss is recognized. The impairment loss is equal to the difference between the book value and the fair market value of the asset. International accounting standards have similar requirements, but these standards allow the asset to be written back up with a reversal of the loss if the value recovers. U.S. accounting standards do not allow the loss to be reversed in future periods.

Auditors should be alert for any changes in circumstances that may affect the recoverability of property, plant, and equipment as well as long-lived intangible assets. Examples of changes in circumstances that should result in a test of impairment include a significant decrease in the market value of the asset, a significant adverse change in the way the asset is used, or an adverse change in the physical condition of the asset. If specific assets appear to be impaired, the auditors should evaluate the reasonableness of management's determination of the impairment loss.

The determination of the amount of an impairment loss often involves subjective estimates as to the fair value of assets. Recall from the discussion in Chapter 5 that fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The best evidence about fair value is obtained when there is an active market for the asset and the value of the asset may be determined by reference to sales of identical assets. However, in many cases, an active market does not exist for the specific asset, and fair value must be determined through the application of a valuation model, often involving discounted cash flows. The accuracy of these estimates of fair value depends on the reasonableness of the model's underlying assumptions.

The audit of estimates of fair values often involves substantial risks of material misstatement. For a particular estimate, the level of risk is influenced by a number of factors, such as the length of the cash flow forecast period, the number of significant and complex assumptions, the degree of subjectivity associated with those assumptions, and the availability of objective data. In auditing the values determined by valuation models, the auditors should evaluate

- The appropriateness of the valuation model used.
- Whether the significant assumptions are reasonable and consistent with economic conditions, existing market information, management's plans and strategies, past experience, other financial statement assumptions, and the risk associated with the cash flows.
- The accuracy, completeness, and relevance of the important data on which the fair value measurements are based.

The auditors should consider the processes and controls used by management to develop the estimates and examine appropriate internal and external data in support of the significant assumptions. The auditors should also consider whether any other information or evidence gathered indicates that one or more significant assumptions are not reasonable. In some cases, the auditors may decide to develop their own estimate of fair value to evaluate the reasonableness of management's estimate.

As a part of their substantive procedures, the auditors may decide to use the work of a valuation specialist. Regardless of whether the specialist is engaged by management or by the auditors, the auditors should evaluate the professional qualifications and experience of the valuation specialist and obtain an understanding of the nature of the specialist's work and conclusions. They should also obtain an understanding of the methods and assumptions used by the specialist and consider any relationship the specialist has with the client.

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Rights	☒

8. Investigate Retirements of Property, Plant, and Equipment during the Year.

The principal purpose of this procedure is to determine whether any property has been replaced, sold, dismantled, or abandoned without such action being reflected in the accounting records. Nearly every thorough physical inventory of plant and equipment reveals missing units of property—units disposed of without a corresponding reduction of the accounts.

If a machine is sold for cash or traded in on a new machine, the transaction generally will involve the use of documents, such as a cash receipts form or a purchase order; the processing of these documents may bring the retirement to the attention of accounting personnel. However, plant assets may be scrapped rather than sold or traded in on new equipment; consequently, there may be no paperwork related to the disappearance of a machine. How is the accounting department expected to know when the asset has been retired?

As explained previously, one method of preventing unrecorded retirements is enforcement of a companywide policy that no plant asset shall be retired from use without prior approval on a special type of serially numbered retirement work order. A copy of the retirement work order is routed to the accounting department, thus providing some assurance that retirements will be reflected in the accounting records.

What specific steps should the auditors take to discover any unrecorded retirements? The following measures often are effective:

- a. If major additions of plant and equipment have been made during the year, determine whether old equipment was traded in or replaced by the new units.
- b. Analyze the Miscellaneous Revenue account to locate any cash proceeds from the sale of plant assets.
- c. If any of the company's products have been discontinued during the year, investigate the disposition of plant facilities formerly used in manufacturing such products.
- d. Inquire of executives and supervisors whether any plant assets have been retired during the year.
- e. Examine retirement work orders or other source documents for authorization by the appropriate official or committee.
- f. Investigate any reduction of insurance coverage to determine whether this was caused by retirement of plant assets.

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Rights	☒

9. Examine Evidence of Legal Ownership of Property, Plant, and Equipment.

To determine that plant assets are the property of the client, the auditors look for such evidence as a deed, a title insurance policy, property tax bills, receipts for payments to a mortgagee, and fire insurance policies. Additionally, the fact that rental payments are not being made is supporting evidence of ownership.

It is sometimes suggested that the auditors may verify ownership of real property and the absence of liens by examination of public records. This step is seldom taken. Inspection of the documentary evidence listed in the preceding section usually provides adequate proof of ownership. If some doubt exists as to whether the client has clear title to property, the auditors should obtain the opinion of the client's legal counsel or request that a title search be performed by a title insurance company.

Possession of a deed is not proof of present ownership because when real property is sold, a new deed is prepared and the seller retains the old one. This is true of title insurance policies as well. Better evidence of continuing ownership is found in property tax bills made out in the name of the client and in fire insurance policies, rent receipts from lessees, and regular payments of principal and interest to a mortgagee or trustee.

The disclosure of liens on property is considered during the examination of liabilities, but in the audit work on plant and equipment, the auditors should be alert for evidence indicating the existence of liens. Purchase contracts examined in verifying the cost of property may reveal unpaid balances. Insurance policies may contain loss payable endorsements in favor of a secured party.

The auditors can readily ascertain the ownership of automobiles and trucks by reference to certificates of title and registration documents. The ease of transfer of title to automotive equipment, plus the fact that it is often used as collateral for loans, makes it important that the auditors examine the title to such property.

10. Review Rental Revenue from Land, Buildings, and Equipment Owned by the Client but Leased to Others.

In testing rental revenue from land and buildings, it is often desirable for the auditors to obtain or to sketch a map of the property and to make a physical inspection of each unit. This may disclose that premises reported as vacant are in fact occupied by lessees and are producing revenue not reflected in the accounting records. If the client's property includes an office or apartment building, the auditors should obtain a floor plan of the

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Rights	☒

building as well as copies of all lease contracts. In this way, they can account for all available rental space as revenue-producing or vacant and can verify reported vacancies by physical inspection at the balance sheet date. If interim audit work is being performed, vacancies should also be verified by inspection and discussion with management during the year.

Examination of leases will indicate whether tenants are responsible for the cost of electricity, water, gas, and telephone service. These provisions should be reconciled with utility expense accounts. Rental revenue accounts should be analyzed in all cases and the amount compared with lease agreements and cash records.

Finally, the auditors should determine that the client is applying the appropriate accounting standards depending on whether the lease terms indicate a sales-type, direct financing, or operating lease. When the lease involves variable payments, the auditors must carefully evaluate when the variable payments should be recognized.

Primary Audit Objectives:	
Existence	☒
Completeness	☒
Rights	☒
Valuation	☒

11. Evaluate and Test the Accounting for Lease Agreements on Property, Plant, and Equipment.

The preceding step addressed rental revenue from leases. The auditors also should be aware that generally accepted accounting principles require differing accounting treatments by lessees for operating and finance leases. In addition, accounting standards require lessees to record a right-of-use asset and lease liability for all leases with terms longer than 12 months (FASB ASC 842). The auditors should carefully examine lease agreements to determine whether the accounting for the assets involved is proper. For example, the auditors should be alert for the client's possible use of improper accounting techniques, such as the following:

- Assets under a lease that are being improperly accounted for (e.g., failure to record asset and liability for leases with terms of more than 12 months).
- Leasehold improvements to buildings under leases that are being depreciated over the estimated useful life of the improvements rather than the shorter term of the lease, when renewal of the lease is not reasonably assured.
- Improper accounting for items such as initial direct costs, lease incentives, and variable payments.

If the client has a large number of lease agreements, the auditors may use artificial intelligence software to read all agreements to identify lease provisions that may affect accounting or disclosure requirements for the specific lease.

Primary Audit Objectives:	
Existence	☒
Completeness	☒
Rights	☒
Valuation	☒

12. Perform Analytical Procedures or Data Analytics for Property, Plant, and Equipment.

The specific trends and ratios used in judging the overall reasonableness of recorded amounts for plant and equipment will vary with the nature of the client's operations. Among the ratios and trends used by auditors for this purpose are the following:

- Total cost of plant assets divided by annual output in dollars, pounds, or other units.
- Total cost of plant assets divided by cost of goods sold.
- Comparison of repairs and maintenance expense on a monthly basis and from year to year.
- Comparison of acquisitions for the current year with prior years.
- Comparison of retirements for the current year with prior years.

Acquisitions and retirements may vary widely from year to year; however, it is essential that the auditors be aware of these variations and judge their reasonableness in the light of trends in the client's past and present operations. Analytical procedures relating to depreciation are discussed later in this chapter as part of the audit program for depreciation.

The objectives of many of these overall analytical procedures may be achieved through the use of data analytic techniques. Data analytics software may perform tasks such as the following:

1. Identifying expenditures that were inappropriately recorded (e.g., an item capitalized that should have been expensed) by computer review of descriptions on invoices.
2. Identifying machinery that has been retired but not written off or not in use by searching maintenance records.

Primary Audit
Objective:

Presentation ☒

13. Evaluate Financial Statement Presentation and Disclosure for Plant Assets and for Related Revenue and Expenses.

The balance sheet or accompanying notes should disclose balances of major classes of depreciable assets. Accumulated depreciation may be shown by major class or in total, and the method or methods of computing depreciation should be stated. The total amount of depreciation should be disclosed in the income statement or supporting notes.

In addition, adequate financial statement presentation and disclosure will ordinarily reflect the following principles:

- a. The basis of valuation should be explicitly stated. At present, cost is the generally accepted basis of valuation for plant and equipment; property not in use should be valued at the lower of cost or estimated realizable value.
- b. Property pledged to secure loans should be clearly identified.
- c. Property not in current use should be segregated in the balance sheet.

Depreciation

The Auditors' Perspective toward Depreciation

LO 13-7

Explain the auditors' approach to the audit of depreciation.

Determining the annual depreciation expense involves two decisions by the client company: first, an estimate of the useful economic lives of various groups of assets and, second, a choice among several depreciation methods, each of which would lead to a different answer. The wide range of possible amounts for annual depreciation expense because of these decisions made by the client suggests that the auditors should maintain a perspective of looking for assurance of overall reasonableness. Specifically, overall tests of the year's depreciation expense are of special importance.

Among the methods of computing depreciation expense most frequently encountered are the straight-line method and the declining-balance method. Far less common, although quite acceptable, are methods based on units of output or hours of service. The most widely adopted types of accelerated depreciation methods are fixed percentage of declining balance and sum-of-the-years' digits. The essential characteristic of these and other similar methods is that depreciation is greatest in the first year and becomes smaller in succeeding years.

CPAs often encounter clients maintaining their records using federal income tax rules, such as the modified accelerated cost recovery system (MACRS). Although such methods are considered a systematic method of depreciating the cost of an asset, the depreciable lives of the assets are often much shorter than their useful economic lives. If the recovery periods are not reasonable, depreciation expense may be materially misstated and the auditors will not be in a position to issue an unqualified opinion on the financial statements.

The Auditors' Objectives in Auditing Depreciation

Depreciation is an accounting estimate. Recall from Chapter 5 that, in evaluating the reasonableness of accounting estimates, auditors first obtain an understanding of the client's processes and controls. Then, they use one or more of the following three basic approaches:

1. Review and test management's process of developing the estimate.
2. Review subsequent events or transactions bearing on the estimate.
3. Independently develop an estimate of the amount to compare to management's estimate.

For depreciation, while a combination of the three approaches may be used, the emphasis is ordinarily upon the first basic approach—reviewing and testing management’s process for calculating depreciation.

As we discussed earlier, depreciation relates most directly to the *valuation* or *allocation* audit objective. To meet this objective, the auditors, in examining management’s process for calculating depreciation, determine that (1) the methods in use are acceptable, (2) the methods are being followed consistently, and (3) the calculations required by the chosen methods are accurate. The audit program in the following section conveys a more detailed picture of the auditors’ objectives.

Audit Program— Depreciation Expense and Accumulated Depreciation

The following outline of substantive procedures to be performed by the auditors in reviewing depreciation is stated in sufficient detail to be largely self-explanatory. Consequently, no point-by-point discussion will be presented. Techniques for testing the client’s provision for depreciation for the year are, however, discussed immediately following the audit program.

1. Review the depreciation policies set forth in company manuals or other management directives. Determine whether the methods in use are designed to allocate costs of plant and equipment assets systematically over their service lives.
 - a. Inquire whether any extra working shifts or other conditions of accelerated production are present that might warrant adjustment of normal depreciation rates.
 - b. Discuss with executives the possible need for recognition of obsolescence resulting from technological or economic developments. For example, assume that a new, improved model of computer has recently become available and that it would fit the company’s needs more effectively. Should the remaining estimated useful life of an older computer presently owned by the company be reevaluated in the light of this technological advance?
2. Obtain or prepare a summary analysis (see Figure 13.1) of accumulated depreciation for the major property classifications as shown by the general ledger control accounts, listing beginning balances, provisions for depreciation during the year, retirements, and ending balances.
 - a. Compare beginning balances with the audited amounts in last year’s working papers.
 - b. Determine that the totals of accumulated depreciation recorded in the plant and equipment subsidiary records agree with the applicable general ledger controlling accounts.
3. Test the provisions for depreciation.
 - a. Compare rates used in the current year with those employed in prior years and investigate any variances.
 - b. Test computations of depreciation provisions for a representative number of units and trace to individual records in the property ledger. Be alert for excessive depreciation on fully depreciated assets. Data analytics can be used to test the depreciation calculations in the client’s records if the client maintains computer-based records.
 - c. Compare credits to accumulated depreciation accounts for the year’s depreciation provisions with debit entries in related depreciation expense accounts.
4. Test deductions from accumulated depreciation for assets retired.
 - a. Trace deductions to the working paper analyzing retirements of assets during the year.
 - b. Test the accuracy of accumulated depreciation to date of retirement.
5. Perform analytical procedures for depreciation.
 - a. Compute the ratio of depreciation expense to total cost of plant and compare with prior years.
 - b. Compare the percentage relationships between accumulated depreciation and related property accounts with those prevailing in prior years. Discuss significant variations from the normal depreciation program with appropriate members of management.

Testing the Client's Provision for Depreciation

We have emphasized the importance of determining the overall reasonableness of the amount of depreciation expense, which is usually a material amount on the income statement. An *overall* test of the annual provision for depreciation requires the auditors to perform the following steps:

1. List the balances in the various asset accounts at the beginning of the year.
2. Deduct any fully depreciated assets because these items should no longer be subject to depreciation.
3. Add one-half of the asset additions for the year.
4. Deduct one-half of the asset retirements for the year (exclusive of any fully depreciated assets).

These four steps produce an estimate of depreciation expense for each of the major asset categories for comparison with the provision for depreciation. Material differences should be investigated.

A more efficient method of testing depreciation expense is often with the use of data analytic techniques. By obtaining the client's computer-readable records of plant and equipment, the auditors can use their audit software to make detailed tests of all of the client's depreciation computations.

Examination of Natural Resources

In the audit of companies' operating properties subject to depletion (mines, oil and gas deposits, timberlands, and other natural resources), the auditors follow a pattern similar to that used in evaluating the provision for depreciation expense and accumulated depreciation. They determine whether depletion has been recorded consistently and in accordance with generally accepted accounting principles, and they test the mathematical accuracy of the client's computations.

The depletion of timberlands is usually based on physical quantities established by **cruiising**. For areas that are difficult to access, the client or the auditors might use drones to assess the yield. The determination of physical quantities to use as a basis for depletion is more difficult in many mining ventures and for oil and gas deposits. The auditors often rely upon the opinions of such specialists as mining engineers and geologists about the reasonableness of the depletion rates being used for such resources. Under these circumstances, the auditors must comply with the requirements of the professional standards on the use of specialists (AICPA AU-C 630 and PCAOB AS 1210), as discussed in Chapter 5.

If the number of tons of ore in a mining property could be accurately determined in advance, an exact depletion cost per ton could be computed by dividing the cost of the mine by the number of tons available for extraction. In reality, the contents of the mine can only be estimated, and the estimates may require significant revision as mining operations progress.

The auditors investigate the ownership and the cost of mining properties by examining deeds, leases, tax bills, vouchers, paid checks, and other records in the same manner that they verify the plant and equipment of a manufacturing or trading concern. The costs of exploration and development work in a mine customarily are capitalized until such time as commercial production begins. After that date, additional development work generally is treated as an expense. The large oil companies capitalize the costs of drilling oil wells only if they are found to be productive. Under this "successful efforts" policy, the costs of drilling wells that prove not to be productive are immediately written off. However, some smaller companies follow an alternative "full-cost" policy, under which all drilling costs are capitalized and amortized over future years.

Audit of Intangible Assets

LO 13-8

Describe how the auditors design audit procedures to audit intangible assets.

The balance sheet caption “Intangible Assets” includes a variety of assets. All intangible assets are characterized by a lack of physical substance. Furthermore, they do not qualify as current assets, and they are nonmonetary—that is, they do not represent fixed claims to cash.

Among the more prominent intangible assets are goodwill, patents, trademarks, franchises, and leases. An intangible asset’s value lies in the rights or economic advantages afforded in its ownership. Because of the intangible nature of these assets, they may be more difficult to identify than physical assets. When a client treats an expenditure as creating an intangible asset, the auditors should look for objective evidence that a genuine asset has come into existence.

The auditors’ substantiation of intangible assets may begin with an analysis of the ledger accounts for these assets. Debits to the accounts should be traced to evidence of payment having been made and to documentary evidence of the rights or benefits acquired. Credits to the accounts should be reconciled with the client’s program of amortization or traced to appropriate authorization for the write-off of the asset.

One intangible asset that may be large in amount yet of questionable future economic benefit is *goodwill*. Goodwill arises in accounting for business combinations in which the price paid to acquire another company exceeds the fair value of the identifiable net assets acquired. When business combinations result in the recording of goodwill, the auditors should review the allocation of the lump-sum acquisition cost among tangible assets, identifiable intangible assets, and goodwill. They should also determine whether goodwill is properly allocated to all the various reporting units acquired in the acquisition. Often, the auditors will have to use the services of a business valuation specialist to assist them in evaluating the reasonableness of the valuation and allocation.

Once goodwill is acquired, it remains at its purchase price; it is not amortized. Instead, goodwill assigned to reporting units should be tested for impairment on an annual basis and between annual tests in certain circumstances. As explained previously, impairment tests involve determining the fair value of the reporting units for comparison to their carrying value. If the fair value of a reporting unit is less than its carrying value, an impairment loss is recognized for the difference.

As part of an analysis of intangible assets with definite useful lives, the auditors should review the reasonableness of the client’s amortization program. Amortization is ordinarily computed by the straight-line method over the assets’ estimated useful lives. As with property, plant, and equipment, long-lived intangible assets should be continually reviewed for impairment when circumstances indicate that the carrying value of the asset may not be recoverable. The issues regarding the potential impairment of intangible assets are similar to those regarding property, plant, and equipment, as discussed earlier in this chapter. If specific intangible assets are at risk for impairment, the auditors should evaluate the reasonableness of management’s evaluation of impairment, including management’s estimate of the fair values of those assets.

Audit of Cryptoassets

In Chapter 8, we introduced the blockchain concept and the Bitcoin trading platform through an *Illustrative Case*. Here we provide a brief overview of the nature of cryptoassets and the related auditing considerations.

Consider a client that owns a number of units of cryptocurrency, such as Bitcoin. When acquired, these units are recorded with a debit to the cryptoasset account and a



Illustrative Case

Asset Impairment



The following excerpt is from Ernst & Young, LLP's audit report for News Corp. a report

that includes a **critical audit matter** on the valuation of goodwill and indefinite-lived intangible assets.

CRITICAL AUDIT MATTER DESCRIPTION

As reflected in the Company's consolidated financial statements, at June 30, 2022, the Company's goodwill was \$5.17 billion and indefinite-lived intangible assets were \$1.03 billion. As disclosed in Note 8 to the consolidated financial statements, goodwill and indefinite-lived intangible assets are tested for impairment at least annually or more frequently if indicators of impairment require the performance of an interim impairment assessment.

Auditing management's impairment tests of goodwill and indefinite-lived intangible assets were complex and highly judgmental due to the significant measurement uncertainty in determining the fair values of the reporting units and indefinite-lived intangible assets. In particular, the fair value estimates of the reporting units were sensitive to changes in significant assumptions such as discount rates, expected future cash flows, long-term growth rates, and comparable company earnings multiples. The fair value estimates for indefinite-lived intangible assets were sensitive to significant assumptions such as discount rates, expected future cash flows, royalty rates, and terminal growth rates. These assumptions are affected by expected future market or economic conditions.

HOW WE ADDRESSED THE MATTER IN OUR AUDIT

We obtained an understanding, evaluated the design, and tested the operating effectiveness of controls over the

Company's goodwill and indefinite-lived intangible asset impairment assessment process. For example, we tested controls over the Company's long range planning process as well as controls over the review of the significant assumptions in estimating the fair values of the reporting units and indefinite-lived intangible assets.

To test the fair values of the reporting units and indefinite-lived intangible assets, our audit procedures included, among others, assessing methodologies, testing the significant assumptions described above, and testing the completeness and accuracy of the underlying data used by the Company. Our testing procedures over the significant assumptions included, among others, comparing forecasted revenue and operating margins, to current industry and economic trends, while also considering changes in the Company's business model, customer base, and product mix. We assessed the historical accuracy of management's estimates by comparing past projections to actual performance and assessed sensitivity analyses of significant assumptions to evaluate the changes in the fair value of the reporting units and indefinite-lived intangible assets resulting from changes in the assumptions. We also involved an internal valuation professional to assist in evaluating the Company's models, valuation methodology, and significant assumptions used in the fair value estimates. We tested management's reconciliation of the fair value of the reporting units to the market capitalization of the Company.

Auditor reporting on critical audit matters was introduced in Chapter 2 and is discussed in detail in Chapter 17.

credit to an account such as cash or revenue, depending upon the source of the funds. Typical cryptoasset transactions may arise from

- Purchasing of the cryptoasset with cash.
- Accepting the cryptoasset for payments.
- Purchasing goods or services using the cryptoasset.
- Exchanging one type of cryptoasset for another type.
- Selling the cryptoasset for cash.

While details related to the nature of the cryptoasset and its holder's use of it may affect valuation, FASB standards state that cryptoassets do not meet its definitions of cash, cash equivalents, financial instruments, or inventory. Accordingly, cryptoassets generally should be accounted for as intangible assets with an indefinite life (FASB ASC 350). As with other intangible assets, they should be tested for impairment and, if found to be impaired, written down to their fair value. A subsequent reversal of the impairment is ordinarily prohibited.

The approach to auditing a particular client's cryptoassets is affected by

- Factors such as the volume and amounts of transactions and the nature of the client's controls over recordkeeping and transaction authorization (e.g., whether the private

key that allows access to the cryptocurrency is properly controlled) and the resulting likelihood and magnitude of potential misstatement.

- Whether the client maintains the control over cryptoassets or the client uses a service organization as custodian for the assets.
- Volatility of market prices of the cryptoasset, which may have a major effect on asset valuation. Many cryptoassets have been affected by extreme volatility, with some subsequently resulting in bankruptcy.

During the risk assessment process, the auditors will assess the risks of material misstatement related to these intangible assets and design further audit procedures. The audit of cryptoassets may require the CPA firm to engage a specialist with skills in areas such as cryptography, distributed ledgers, valuation, and related laws.

If the cryptoasset is owned by the client, sufficient audit expertise must exist to address the various financial statement assertions. For example, the auditors need to address the existence, rights, and valuation of the intangible asset, not just that an amount is shown on a computer screen under an unidentified account. A major difficulty with the audit of a cryptoasset is the owner of the account is not identified by the aggregated ledger. Instead, the amounts are tied to an account accessed by a private key (access passcodes), unless the asset is held by an institution (e.g., a broker) in an owner identified account. This concealment of the account user's real identity may make it difficult to determine whether the client owns the assets and all transactions have been identified. As an example of an audit procedure to address ownership, the auditors may decide to observe a client recording a small transaction in the account to provide evidence that the client has rights to the asset. Also, an understanding of controls over the generation and management of private keys is particularly important to addressing risks relating to inappropriate access and improper transactions relating to the cryptoassets.

As indicated above, the client may have engaged an institution (service organization) to assist with its control over processing of the cryptoasset transactions and maintaining custody of the assets. In such a situation, the auditors should confirm the details of the account with the institution. Based on the risk of material misstatement of the account, the auditors may also wish to obtain a Type 2, SOC 1 (Service Organization Control 1) report on the institution's controls over the processing and maintenance of cryptoassets, as described in Chapter 7. Particularly important to the auditors here is determining whether the service organization's report adequately addresses the controls related to the accurate financial reporting of the cryptoassets. If a SOC report is not available or all relevant controls are covered by the report, controls may need to be tested directly by the auditors at the service organization to obtain sufficient appropriate audit evidence.

Audit of Plant, Equipment, and Intangibles in Advance of the Balance Sheet Date

Most of the audit work on plant, equipment, and intangibles can be done in advance of the balance sheet date. For the initial audit of a new client, the time-consuming task of reviewing the records of prior years and establishing the beginning balances in the accounts for the current period ordinarily will be completed before the year-end.

In repeat engagements, as well as in first audits, the consideration of internal control can be carried out at a convenient time during the year. Many auditing firms lighten their year-end workloads by performing interim work during October and November, including the analysis of the plant and equipment ledger accounts for the first 9 or 10 months of the year. After the balance sheet date, the work necessary on property accounts is then limited to examination of the transactions for the final two or three months.

Chapter Summary

In this chapter, we presented the appropriate controls for property, plant, and equipment accounts; the auditors' consideration of these controls; and the substantive procedures for property, plant, and equipment. To summarize:

1. The financial statement caption "Property, Plant, and Equipment" includes tangible assets with a useful life of more than one year that are used in operations. In the audit of property, plant, and equipment, the auditors' primary substantive procedure objectives are to (a) substantiate the existence of property, plant, and equipment and the occurrence of related transactions; (b) establish the completeness of recorded property, plant, and equipment; (c) verify the cutoff of transactions affecting property, plant, and equipment; (d) determine that the client has rights to the recorded property, plant, and equipment; (e) establish the proper valuation or allocation of property, plant, and equipment and the accuracy of related transactions; and (f) evaluate the adequacy of presentation and disclosure for property, plant, and equipment.
2. Key controls over property, plant, and equipment should include proper authorization of acquisitions, adequate records for the various units of property, periodic physical inspection of property, and the use of serially numbered retirement work orders.
3. In the audit of property, plant, and equipment for a continuing client, the emphasis of the testing is on transactions that occurred during the year, as contrasted to an emphasis on ending balances. Depreciation expense is often tested by recomputation or through the use of analytical procedures.
4. The auditors' objectives for the audit of natural resources and intangible assets are similar to those for property, plant, and equipment. Often in auditing the depletion of natural resources, the auditors should rely upon specialists to estimate the quantity and quality of the resource. The audit of intangible assets typically involves vouching the cost of the assets and evaluating and testing the allocation methods used by the client. Under current accounting, virtually all leases are capitalized at the present value of the future payments. The right-of-use asset is amortized over the period the client is expected to have control over the asset. Cryptoassets owned by a client are accounted for as intangible assets. When they encounter the assets, the auditors must have sufficient expertise to audit the related financial statement assertions.
5. In some audits, a substantial risk with respect to property, plant, and equipment and intangible assets is the risk of unrecognized impairment.

Key Terms Introduced or Emphasized in Chapter 13

Capital expenditure (637) An expenditure for property, plant, and equipment that is properly charged to an asset account.

Critical audit matter (CAM) (652) **Critical audit matter** a matter that was communicated or required to be communicated to the audit committee and that (1) relates to accounts or disclosures that are material to the financial statements, and (2) involved especially challenging, subjective, or complex auditor judgment. Critical audit matters are communicated for the audits of public companies.

Cruising (650) The visual inspection of a tract of forestland for the purpose of estimating the total lumber yield.

Management review controls (639, 642, 636) Reviews conducted by management of estimates and other kinds of financial information for reasonableness. They often involve the use of significant judgment, knowledge, and experience in comparing recorded amounts with expectations of the reviewers. They often are considered monitoring controls but may relate to any of the other COSO components that have the common characteristic of management review of information to identify misstatements or breakdowns in other controls.

Revenue expenditure (637) An expenditure for property, plant, and equipment that is properly charged to an expense account.

Work order (636) A serially numbered accounting document authorizing the acquisition of plant assets. A separate series of retirement work orders may be used to authorize the retirement or disposal of plant assets, and a third variety consists of documents authorizing repair or maintenance of plant assets.

Review Questions

- 13-1. The auditors' verification of plant and equipment is facilitated by several factors not applicable to audit work on current assets. What are these factors?
- 13-2. K-J Corporation has current assets of \$5 million and approximately the same amount of plant and equipment. Should the two groups of assets require about the same amount of audit time? Give reasons.
- 13-3. What are the objectives of establishing internal control over plant and equipment?
- 13-4. Identify at least three elements of strong internal control over property, plant, and equipment.
- 13-5. Explain the use of a system of authorizations for additions to plant and equipment.
- 13-6. Moultrie Company discovered recently that a number of its property and equipment assets had been retired from use several years ago without any entries being made in the accounting records. The company asks you to suggest procedures that will prevent unrecorded retirement of assets.
- 13-7. Does a failure to record the retirement of machinery affect net income? Explain.
- 13-8. The auditors' verification of current assets such as cash, securities, and inventories emphasizes observation, inspection, and confirmation to determine the physical existence of these assets. Should the auditors take a similar approach to establish the existence of the recorded plant assets? Explain fully.
- 13-9. You are making your first audit of Clarke Manufacturing Company. The Plant and Equipment account represents a very substantial portion of the total assets. What verification, if any, will you make of the balances of the ledger accounts for Plant and Equipment as of the beginning of the period under audit?
- 13-10. What documentary evidence is usually available to the auditors in the client's office to substantiate the legal ownership of property, plant, and equipment?
- 13-11. Should the auditors examine public records to determine the legal title of property apparently owned by the client?
- 13-12. In response to threats from a terrorist organization, Technology International installed protective measures consisting of chain-link fences, concrete road barriers, electronic gates, and underground parking at its manufacturing facilities. The costs of these installations were debited to the Land account. Indicate with reasons your approval or disapproval of this accounting treatment.
- 13-13. Should the independent auditors observe a physical inventory of property and equipment in every audit engagement? Discuss.
- 13-14. Hamlin Metals Company has sales representatives covering several states and provides automobiles for them and for its executives. Describe any substantive procedures you would consider appropriate for the company's fleet of more than 100 automobiles, other than the verification procedures generally applicable to all property and equipment.
- 13-15. What is a principal objective of the auditors in analyzing a Maintenance and Repairs expense account?
- 13-16. Gibson Manufacturing Company acquired new factory machinery this year and ceased using the old machinery. The old equipment was retained, however, and is capable of being used if the demand for the company's products warrants additional production. How should the old machinery be handled in the accounting records and on the financial statements?
- 13-17. List three substantive procedures the auditors could use to detect unrecorded retirements of property, plant, and equipment.
- 13-18. Do the auditors question the service lives adopted by the client for plant assets, or do they accept the service lives without investigation? Explain.
- 13-19. Explain why the auditors may need to use the work of a specialist in the audit of goodwill.
- 13-20. Explain how the existence of lease agreements may result in understated plant and equipment.
- 13-21. Suggest several comparisons to be made as part of the auditors' analytical procedures for
 - a. Plant and Equipment.
 - b. Depreciation.

Questions Requiring Analysis LO 13-1, 2

Select questions are available with Connect



- 13–22. Assume that a continuing audit client has recorded Accounts Receivable and Equipment both in the amount of \$1,000,000. In a typical audit, which account would take more time to audit?
(AICPA, adapted)
- LO 13-1, 3, 5** 13–23. An executive of a manufacturing company informs you that no formal procedures have been followed to control the retirement of machinery and equipment. A physical inventory of plant assets has just been completed. It revealed that 25 percent of the assets carried in the ledger were not on hand and had presumably been scrapped. The accounting records have been adjusted to agree with the physical inventory. Outline internal control practices to govern future retirements.
- LO 13-4, 6, 8** 13–24. Gruen Corporation is a large diversified company with a large amount of property, plant, and equipment and intangible assets, including goodwill. In the past year the company has experienced a significant decline in a number of its lines of business.
- What risk of material misstatement is indicated from the information provided?
 - Describe how the auditors would generally obtain evidence about the value of goodwill.
- LO 13-1, 3, 4, 6** 13–25. Kraft Corporation, a small manufacturing company, did not use the services of independent auditors during the first two years of its existence. Near the end of the third year, Kraft retained Jones & Scranton, CPAs, to perform an audit for the year ended December 31. Officials of the company requested that the CPA firm perform only the audit work necessary to provide an audit report on the financial statements for the current year.
- During the first two years of its operation, Kraft had erroneously treated some material acquisitions of plant and equipment as revenue expenditures. No such errors occurred in the third year.
- Under these circumstances, would Jones & Scranton, CPAs, be likely to learn of the transactions erroneously treated as revenue expenditures in years 1 and 2? Explain.
 - Would the income statement and balance sheet prepared at the end of year 3 be affected by the above accounting errors made in years 1 and 2? If so, identify the specific items. Explain fully.
- LO 13-1, 2, 4** 13–26. Allen Fraser was president of three corporations: Missouri Metals Corporation, Kansas Metals Corporation, and Iowa Metals Corporation. Each of the three corporations owned land and buildings acquired for approximately \$500,000. An appraiser retained by Fraser in 20X1 estimated the current value of the land and buildings in each corporation at approximately \$3,000,000. The appraisals were recorded in the accounts. A new corporation, called Midwest Corporation, was then formed, and Fraser became its president. The new corporation purchased the assets of the three predecessor corporations, making payment in capital stock. The balance sheet of Midwest Corporation shows land and buildings “valued at cost” in the amount of \$9,000,000, the carrying values to the vendor companies at the time of transfer to Midwest Corporation. Do you consider this treatment acceptable? Explain.
- LO 13-1, 3, 6** 13–27. Your new client, Watson Products Inc., completed its first fiscal year March 31, 20X4. During the course of your audit, you discover the following entry in the general journal, dated April 1, 20X3. This entry resulted in a transaction with Watson Construction Co. Both Watson Products Inc. and Watson Construction Co. are owned by J. A. Watson.

Building	2,400,000
Mortgage Note Payable	1,400,000
Common Stock	1,000,000

To record (1) acquisition of building constructed by J. A. Watson Construction Co. (a sole proprietorship); (2) assumption of Watson Construction Co. mortgage loan for construction of the building; and (3) issuance of entire authorized common stock (10,000 shares, \$100 par value) to J. A. Watson.

Under these circumstances, what steps should the auditors take to verify the \$2,400,000 recorded cost of the building? Explain fully.

- LO 13-1, 3, 4, 6** 13-28. Shortly after you were retained to audit the financial statements of Luber Corporation, you learned from a preliminary discussion with management that the corporation had recently acquired a competing business, the Morris Company. In your study of the terms of the acquisition, you find that the total purchase price was paid in cash and that the transaction was authorized by the board of directors and fully described in the minutes of the directors' meetings. The only aspect of the acquisition of the Morris Company that raises any doubts in your mind is the allocation of the total purchase price among the several kinds of assets acquired. The allocation, which had been specifically approved by the board of directors of Luber Corporation, placed very high values on the tangible assets acquired and allowed nothing for goodwill. You are inclined to believe that the allocation of the lump-sum price to the several types of assets was somewhat unreasonable because the total price for the business was as much as or more than the current replacement cost of the tangible assets acquired. However, as an auditor, you do not claim to be an expert in property values. Would you question the propriety of the directors' allocation of the lump-sum purchase price? Explain fully.
- LO 13-6** 13-29. List and state the purpose of all audit procedures that might reasonably be applied by the auditors to determine that all property and equipment retirements have been recorded in the accounting records.
- LO 13-8** 13-30. Girard Corporation has just completed the acquisition of Williams Inc. at a purchase price significantly higher than the fair values of the identifiable assets. Describe the audit issues caused by the acquisition and how the auditors would likely resolve the issues.
- LO 13-1, 4, 6** 13-31. You are part of the audit team that is auditing Happy Chicken Inc., a company that franchises Happy Chicken family restaurants. During the current year, management of Happy Chicken purchased for \$2 million one of its franchised locations, a store that was having financial difficulties. In performing its analysis for impairment of assets at year-end, management of Happy Chicken determined that the carrying value of the asset may not be recoverable. As a result, management developed an estimate of the fair value of the location using a discounted cash flow model. The estimated fair value of the location was determined to be \$1.5 million, which resulted in an impairment loss of about \$500,000. The undiscounted future cash flows are equal to \$1.7 million.
- State why the audit of fair values is often difficult.
 - Describe how you might approach the audit of the impairment loss in this situation.
 - If you decide to use the work of a valuation specialist to audit the estimate of fair value, describe your responsibilities with respect to using the specialist's work.
 - List two significant assumptions that you would expect to underlie Happy Chicken management's estimate of the fair value of its recently purchased franchise location.
 - For the significant assumptions that you identified in part (d), describe the types of evidence that you would expect to examine in order to support those assumptions.
- LO 13-8** 13-32. In your audit of Ripley Corp., you discover that Ripley has accepted Bitcoins for the sale of certain products. At the balance sheet date, Ripley has a significant number of Bitcoins on its balance sheet.
- Describe how Ripley should have recorded the sale of the products for Bitcoins.
 - Identify the assertion that is particularly difficult to audit with respect to the Bitcoin asset.
 - Describe the manner in which the auditors might audit the assertion identified in item (b).
 - How would your answer to item (c) change if the Bitcoins were maintained in a brokerage account for Ripley?

Objective Questions

LO 13-3, 5

- 13-33. **Multiple Choice Questions**
Select the best answer for each of the questions below and explain fully the reason for your selection.
- To assure accountability for fixed-asset retirements, management should implement an internal control that includes:
 - (1) Continuous analysis of miscellaneous revenue to locate any cash proceeds from the sale of plant assets.
 - (2) Periodic inquiry of plant executives by internal auditors as to whether any plant assets have been retired.
 - (3) Utilization of serially numbered retirement work orders.
 - (4) Periodic observation of plant assets by the internal auditors.

LO 13-6, 7

- b. The auditors may conclude that depreciation charges are insufficient by noting:
- (1) Insured values greatly in excess of book values.
 - (2) Large amounts of fully depreciated assets.
 - (3) Continuous trade-ins of relatively new assets.
 - (4) Excessive recurring losses on assets retired.

LO 13-3, 5

- c. Which of the following is an internal control weakness related to factory equipment?
- (1) Checks issued in payment of purchases of equipment are not signed by the controller.
 - (2) All purchases of factory equipment are required to be made by the department in need of the equipment.
 - (3) Factory equipment replacements are generally made when estimated useful lives, as indicated in depreciation schedules, have expired.
 - (4) Proceeds from sales of fully depreciated equipment are credited to other income.

LO 13-6

- d. Which of the following accounts should be reviewed by the auditors to gain reasonable assurance that additions to property, plant, and equipment are *not* understated?
- (1) Depreciation.
 - (2) Accounts Payable.
 - (3) Cash.
 - (4) Repairs.

LO 13-5, 6

- e. The auditors are most likely to seek information from the plant manager with respect to the:
- (1) Adequacy of the provision for uncollectible accounts.
 - (2) Appropriateness of physical inventory observation procedures.
 - (3) Existence of obsolete machinery.
 - (4) Deferral of procurement of certain necessary insurance coverage.

LO 13-3, 5

- f. To strengthen internal control over the custody of heavy mobile equipment, the client would most likely institute a policy requiring a periodic:
- (1) Increase in insurance coverage.
 - (2) Inspection of equipment and reconciliation with accounting records.
 - (3) Verification of liens, pledges, and collateralizations.
 - (4) Accounting for work orders.

LO 13-1

- g. Which of the following statements is *not* typical of property, plant, and equipment as compared to most current asset accounts?
- (1) A property, plant, and equipment cutoff error near year-end has a more significant effect on net income.
 - (2) Relatively few transactions occur in property, plant, and equipment during the year.
 - (3) The assets involved with property, plant, and equipment ordinarily have relatively longer lives.
 - (4) Property, plant, and equipment accounts typically have a higher dollar value.

LO 13-1, 6

- h. For the audit of a continuing nonpublic client, the emphasis of the testing for property accounts is on:
- (1) All transactions resulting in the ending balance.
 - (2) Tests of controls over disposals.
 - (3) Transactions that occurred during the year.
 - (4) Performing analytical procedures on beginning balances of the accounts.

LO 13-2, 6

- i. Audit of which of the following accounts is most likely to reveal evidence relating to recorded retirements of equipment?
- (1) Accumulated depreciation.
 - (2) Cost of goods sold.
 - (3) Purchase returns and allowances.
 - (4) Purchase discounts.

LO 13-2, 6

- j. An effective procedure for identifying unrecorded retirements of equipment is to:
- (1) Foot related property records.
 - (2) Recalculate depreciation on the related equipment.
 - (3) Select items of equipment in the accounting records and then locate them in the plant.
 - (4) Select items of equipment and then locate them in the accounting records.

LO 13-7

- k. Which of the following is *not* an overall test of the annual provision for depreciation expense?
- (1) Compare rates used in the current year with those used in prior years.
 - (2) Test computation of depreciation provisions for a representative number of units.
 - (3) Test deductions from accumulated depreciation for assets purchased during the year.
 - (4) Perform analytical procedures.

LO 13-8

- l. The audit of intangible assets typically involves

	Vouching the Cost of Assets	Testing Allocation Methods
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

LO 13-6 13–34. Objective Question

Hwang Corporation has engaged in a number of expenditures relating to a land acquisition for a future plant. For each of the following, indicate whether you as the auditor of Hwang Corporation would propose an adjusting entry. Assume all transactions are material.

Yes—indicates a proposed adjusting entry is necessary.

No—indicates no proposed adjusting entry is necessary.

Situation	Propose an Adjusting Entry?
a. Hwang purchased land for a new plant that it intends to construct. A portion of the cost was a commission paid to a real estate agent. That commission was capitalized as part of the cost of the land.	
b. The purchased land was in part financed through obtaining a loan from a financial institution. Interest on that loan is being capitalized as part of the cost of the land.	
c. An existing building on the land was torn down to allow construction of a new building on the land. The cost of the demolition was capitalized as part of the cost of the new building.	
d. Subsequent to the land purchase, Hwang purchased certain equipment from a vendor who had filed for bankruptcy. Hwang's management believes that the equipment was purchased for an amount equal to approximately half what at least one other supplier sells it for. Hwang recorded the transaction at its cost.	
e. Hwang cut down a number of trees on the land and sold the wood. Other income was recorded on the transaction for the amount of the cash received.	

LO 13-3, 6, 7, 8 13–35. **Multiple Choice Questions**

- a. Analysis of which account is *least* likely to reveal evidence relating to recorded retirement of equipment?
 - (1) Accumulated depreciation.
 - (2) Insurance expense.
 - (3) Property, plant, and equipment.
 - (4) Purchase returns and allowances.
- b. Which of the following explanations most likely would satisfy an auditor who questions management about significant debits to the accumulated depreciation accounts?
 - (1) The estimated remaining useful lives of plant assets were revised upward.
 - (2) Plant assets were retired during the year.
 - (3) The prior year's depreciation expense was erroneously understated.
 - (4) Overhead allocations were revised at year-end.
- c. Treetop Corporation acquired a building and arranged mortgage financing during the year. Verification of the related mortgage acquisition costs would be least likely to include an examination of the related:
 - (1) Deed.
 - (2) Canceled checks.
 - (3) Closing statement.
 - (4) Interest expense.
- d. In testing plant and equipment balances, an auditor may select recorded additions in the analysis of plant and equipment and inspect the actual asset(s) involved. Which management assertion is this procedure most directly related to?
 - (1) Existence.
 - (2) Completeness.
 - (3) Rights.
 - (4) Valuation.
- e. A search for overstated property, plant, and equipment purchases would most likely include:
 - (1) Accounts receivable.
 - (2) Property, plant, and equipment.
 - (3) Purchase discounts.
 - (4) Repairs and maintenance expense.

LO 13-8 13–36 **Multiple Choice Questions**

- a. Which financial statement assertion is impairment of intangible assets most directly related to?
 - (1) Completeness.
 - (2) Existence.
 - (3) Rights.
 - (4) Valuation.
- b. Which of the following is correct relating to goodwill with an indefinite life?
 - (1) It is valued at its year-end fair value, regardless of whether that fair value exceeds or is less than cost.
 - (2) It is valued at purchase price, unless it is impaired.
 - (3) Its cost is amortized over a period of 40 years or less.
 - (4) Its existence requires financial statement note disclosure, but it has no recorded value in the financial statements.
- c. In your audit you have identified that a client has recorded a transaction with a debit to "Bitcoin" and a credit to cash. At year-end, any "Bitcoin" held should be included in:
 - (1) Cash.
 - (2) Intangible assets.
 - (3) Investments.
 - (4) Property, plant, and equipment.

- d. The auditors have audited a client's cryptoassets. Those assets originally cost \$100,000 in 20X1, but in 20X3 were judged as impaired and reported on the financial statement at \$80,000. This year, the estimated fair value of the cryptoassets is \$85,000. Under GAAP, the auditors would expect the proper valuation of the account is most likely to be:
- (1) \$ 80,000.
 - (2) \$ 82,500.
 - (3) \$ 85,000.
 - (4) \$100,000
- e. Which of the following is most likely to be helpful to the auditor in obtaining sufficient appropriate audit evidence relating to cryptoassets?
- (1) A machine count of various types of cryptoassets available for purchase.
 - (2) Confirming the amount through use of an accounts receivable confirmation form.
 - (3) Observing the client's count of cryptocurrency.
 - (4) The client providing a SOC report on controls at the service organization with custody of the assets.

Problems

LO 13-3, 4, 5, 6

- 13–37. The following are typical questions that might appear on an internal control questionnaire relating to plant and equipment:

1. Has a dollar minimum been established for expenditures to be capitalized?
 2. Are subsidiary ledgers for plant and equipment regularly reconciled with general ledger controlling accounts?
- a. State the purpose of each of the above controls.
- b. Describe the manner in which each of the above procedures might be tested.
- c. Assuming that the operating effectiveness of each of the above procedures is found to be inadequate, describe how the auditors might alter their substantive procedures to compensate for the increased level of risks of material misstatements.

LO 13-1, 2, 4

- 13–38. Assume that you are auditing the financial statements of Agee Corporation. During the course of the audit, you discover the following circumstances.

1. Management of Agee has decided to discontinue the production of consumer electronics, which represents a moderately large line of business for the company.
2. In auditing facility rent expense, you note that the amount is about 30 percent less than in the prior year. When you discuss the matter with management, you are informed that the company previously had leased the building on a 12-month lease. However, the company entered into a 10-year building lease agreement at the beginning of the year (about nine months ago), which provided for no lease payments for the first four months of the lease. Therefore, rent expense was less than for the prior year.
3. Management has provided you with the following information about a test of impairment of the company's Clothing and Apparel reporting unit and a large piece of equipment used in the consumer products division of the company. The Clothing and Apparel reporting unit has \$1,200,000 in goodwill associated with it.

Clothing and Apparel Reporting Unit

Carrying value of the unit	\$12,600,000
Discounted value of estimated future cash flows	12,200,000
Market value of the unit	11,500,000

Equipment

Carrying value of the equipment	\$ 1,200,000
Undiscounted estimated future cash flows	1,250,000
Discounted value of estimated future cash flows	1,000,000
Market value of the equipment	975,000

Describe the implications of each of these circumstances, including any additional information or evidence that the auditors might require to resolve the issues identified.

LO 13-1, 4, 6

- 13–39. You are engaged in the audit of the financial statements of Micro Corporation for the year ended December 31, 20X6. The accompanying analyses of the Property, Plant, and Equipment and related accumulated depreciation accounts have been prepared by the chief

accountant of the client. You have traced the beginning balances to your prior year's audit working papers.

MICRO CORPORATION Analysis of Property, Plant, and Equipment and Related Accumulated Depreciation Accounts Year Ended December 31, 20X6				
Description	Final 12/31/X5	Assets		Per Ledger 12/31/X6
		Additions	Retirements	
Land	\$422,500	\$ 5,000		\$427,500
Buildings	120,000	17,500		137,500
Machinery and equipment	385,000	40,400	\$26,000	399,400
	<u>\$927,500</u>	<u>\$62,900</u>	<u>\$26,000</u>	<u>\$964,400</u>

Description	Final 12/31/X5	Accumulated Depreciation		Per Ledger 12/31/X6
		Additions*	Retirements	
Buildings	\$ 60,000	\$ 5,150		\$ 65,150
Machinery and equipment	173,250	39,220		212,470
	<u>\$233,250</u>	<u>\$44,370</u>		<u>\$277,620</u>

*Depreciation expense for the year.

All plant assets are depreciated on the straight-line basis (no residual value taken into consideration) based on the following estimated service lives: building, 25 years; all other items, 10 years. The company's policy is to take one half-year's depreciation on all asset additions and disposals during the year.

Your audit revealed the following information:

1. The company completed the construction of a wing on the plant building on June 30. The service life of the building was not extended by this addition. The lowest construction bid received was \$17,500, the amount recorded in the Buildings account. Company personnel constructed the addition at a cost of \$16,000 (materials, \$7,500; labor, \$5,500; and overhead, \$3,000).
2. On August 18, \$5,000 was paid for paving and fencing a portion of land owned by the company and used as a parking lot for employees. The expenditure was charged to the Land account.
3. The amount shown in the machinery and equipment asset retirement column represents cash received on September 5 upon disposal of a machine purchased in July 20X2 for \$48,000. The chief accountant recorded depreciation expense of \$3,500 on this machine in 20X6.
4. Harbor City donated land and a building appraised at \$100,000 and \$400,000, respectively, to Micro Corporation for a plant. On September 1, the company began operating the plant. Since no costs were involved, the chief accountant made no entry for the above transaction.

Prepare the adjusting journal entries that you would propose at December 31, 20X6, to adjust the accounts for the above transactions. Disregard income tax implications. The accounts have not been closed. Computations should be rounded off to the nearest dollar. Use a separate adjusting journal entry for each of the preceding four paragraphs.

(AICPA, adapted)

- LO 13-1, 4, 6** 13–40. Chem-Lite Inc. maintains its accounts on the basis of a fiscal year ending March 31. At March 31, 20X1, the Equipment account in the general ledger appeared as shown below. The company uses straight-line depreciation, a 10-year life, and 10 percent salvage value for all its equipment. It is the company's policy to take a full year's depreciation on all additions to equipment occurring during the fiscal year, and you may treat this policy as a satisfactory one

for the purpose of this problem. The company has recorded depreciation for the fiscal year ended March 31, 20X1.

Equipment		
4/1/X0 Bal. forward	100,000	
12/1/X0	10,500	
1/2/X1	1,015	
2/1/X1	1,015	
3/1/X1	1,015	

Upon further investigation, you find the following contract dated December 1, 20X0, covering the acquisition of equipment:

List price	\$30,000
5% sales tax	1,500
Total	\$31,500
Down payment	10,500
Balance	21,000
8% interest, 24 months	3,360
Contract amount	<u>\$24,360</u>

Prepare in good form, including full explanations, the adjusting entry (entries) you would propose as auditor of Chem-Lite Inc. with respect to the equipment and related depreciation accounts at March 31, 20X1. (Assume that all amounts given are material.)

(AICPA, adapted)

- LO 13-1, 4, 6** 13-41. You are the senior accountant in the audit of Granger Grain Corporation, whose business primarily involves the purchase, storage, and sale of grain products. The corporation owns several elevators located along navigable water routes and transports its grain by barge and rail. Your staff assistant submitted the following working paper analysis for your review:

GRANGER GRAIN CORPORATION	
Advances Paid on Barges Under Construction—a/c 210	
December 31, 20X1	
Advances made:	
1/15/X1—Ck. No. 3463—Jones Barge Construction Co.	\$100,000*
4/13/X1—Ck. No. 4129—Jones Barge Construction Co.	25,000*
6/19/X1—Ck. No. 5396—Jones Barge Construction Co.	63,000*
Total payments	188,000
Deduct cash received 9/1/X1 from City Life Insurance Co.	188,000 [†]
Balance per general ledger—12/31/X1	<u>\$ —0—</u>

*Examined approved check request and paid check and traced to cash disbursements journal.

[†]Traced to cash receipts journal and to duplicate deposit ticket.

- In what respects is this brief analysis incomplete for audit purposes? (Do not include any discussion of specific auditing procedures.)
- What two different types of contractual arrangements may be inferred from your assistant's analysis?
- What additional auditing procedures would you suggest that your staff assistant perform before you accept the working paper as being complete?

(AICPA, adapted)

In-Class Team Case

LO 13-1, 3, 6

- 13-42. You are reviewing the property, plant, and equipment working papers of Mandville Corporation, a company that publishes travel guides. The lead schedule for the account is included in the chapter as Figure 13.1. The following are among the findings relating to changes in the account:

1. *Land*: The addition represents the purchase of land adjacent to the company's existing plant and is financed as follows:

Contract sales price—2,000 shares of Mandville Corporation Common Stock	
Liabilities assumed by Mandville	
Accrued county taxes at settlement date	(4,600)
Unpaid sewer installation assessment	(6,400)

On June 17, the date on which the buyer and seller discussed the transaction, shares of Mandville Corporation stock were selling for \$77.50. On June 30, the settlement date (day of the sale), Mandville stock was selling for \$70.00 per share. The journal entry for the purchase was recorded as:

Land	\$151,000	
Common Stock		\$ 20,000
Paid-in capital in excess of par		120,000
Accrued taxes payable		4,600
Accrued sewer assessment payable		6,400

Examination of publicly available records has indicated that prices of comparable land in the area have been relatively constant, selling in a range from \$140,000 to \$160,000 during the past 18 months.

2. *Land improvements*: This account was increased by three journal entries (each recorded with a debit to land improvements and a credit to cash) during the year. Each of these improvements relates to the new land that was purchased in point (1) above.

Sidewalk to building	\$2,500
Repaving of road to building	3,500
Chain-link fence (replaced rusted chain-link fence surrounding property)	4,000

3. *Building*: The building was constructed by an independent contractor; the contract was for \$473,000. Progress payments were made during construction through use of proceeds of a bank loan, for which the building serves as collateral. The interest during construction was capitalized (\$22,000), while the interest subsequent to construction but prior to year-end (\$20,000) was expensed.
4. *Equipment*: The change in the equipment was a trade of old book "update printing equipment" for two new computer servers and associated software that will maintain electronic updates. Until recently, updates of outdated portions of guidebooks were printed and "shrinkwrapped" with the guidebook. Now the updates will be available on Mandville's website. The old equipment had a cost of \$60,000 and accumulated depreciation of \$50,600 and was worth approximately its book value of \$9,400, although the salesperson suggested that he was providing the company a \$19,400 trade-in value. Accordingly, the following entry was made to record the exchange:

Equipment—computer servers	\$110,000	
Accumulated Depr. (old equipment)	50,600	
Cash		\$ 90,600
Equipment—printing equipment		60,000
Gain on exchange of assets		10,000

5. *Depreciation provisions:* Mandville uses software to calculate depreciation to the exact day.
- For additions (1) through (4) above, prepare any necessary adjusting entries. If in any case your adjusting entry relies upon an assumption, provide that assumption.
 - For item (5), prepare a calculation of the depreciation provisions and determine whether they appear reasonable. For this calculation, assume that acquisitions, on average, occur at mid-year. If the provision does *not* appear reasonable, discuss follow-up procedures related to the provisions. Use the following table for your calculation:

Acct.	Rate	Depr. on Beg. Balance	Add: Depr. on Additions	Less: Depr. on Retirements	Est. Depr.	Book Depr.	Difference
152-3	5%						
154-5	3%						
156-7	10%						
Totals							

Accounts Payable and Other Liabilities

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 14-1** Describe the nature of accounts payable and other liabilities.
- LO 14-2** Describe the auditors' objectives in the audit of accounts payable.
- LO 14-3** Identify and explain the fundamental controls over payables.
- LO 14-4** Use the understanding of the client and its environment to consider inherent risks (including fraud risks) related to accounts payable.
- LO 14-5** Obtain an understanding of internal control over accounts payable.
- LO 14-6** Assess the risks of material misstatement of accounts payable and design further audit procedures, including tests of controls and substantive procedures, to address the risks.

In this chapter, we discuss accounts payable and other current liabilities. Chapter 15 includes material on long-term debt, equity capital, and loss contingencies.

Accounts Payable

Sources and Nature of Accounts Payable

LO 14-1

Describe the nature of accounts payable and other liabilities.

The term *accounts payable* (often referred to as *vouchers payable* for a voucher system) is used to describe short-term obligations arising from the purchase of goods and services in the ordinary course of business. Typical transactions creating accounts payable include the acquisition on credit of merchandise, raw materials, plant assets, and office supplies. Other sources of accounts payable include the receipt of services, such as legal and accounting services, advertising, repairs, and utilities. Interest-bearing obligations should not be included in accounts payable but shown separately as bonds, notes, mortgages, or installment contracts.

Invoices and statements from suppliers usually support accounts payable arising from the purchase of goods or services and most *other liabilities*. However, **accrued liabilities** (sometimes called *accrued expenses*) generally accumulate over time, and management must make accounting estimates of the year-end liability. Such estimates are often necessary for salaries, pensions, interest, rent, taxes, and similar items.

The Auditors' Objectives in Auditing Accounts Payable

LO 14-2

Describe the auditors' objectives in the audit of accounts payable.

The auditors' *objectives* in the audit of accounts payable are to

1. Use the understanding of the client and its environment to consider *inherent risks*, including fraud risks, related to accounts payable.
2. Obtain an understanding of *internal control* over accounts payable.
3. Assess the risks of material misstatement and design tests of controls and substantive procedures that
 - a. Substantiate the *existence* of accounts payable and the client's *obligation* to pay these liabilities, and establish the *occurrence* of purchase transactions.
 - b. Establish the *completeness* of recorded accounts payable.
 - c. Verify the *cutoff* of purchase transactions.
 - d. Establish the proper *valuation* of accounts payable and the *accuracy* of purchase transactions.
 - e. Determine that the *presentation* and *disclosure* of information about accounts payable are appropriate.

Lawsuits against CPA firms often allege that the auditors failed to detect an overstatement of earnings. Management, especially of publicly held firms, is often under some pressure to report increased earnings. In previous chapters, we discussed the

auditors' concern about overstated earnings resulting from the overstatement of assets. In the audit of liabilities, the auditors are primarily concerned with the possibility of understated or omitted liabilities. An *understatement of liabilities* will exaggerate the financial strength of a company and conceal fraud just as effectively as an *overstatement of assets*. Furthermore, the understatement of liabilities is usually accompanied by the understatement of expenses and an overstatement of net income. For example, delaying the recording of bills for December operating expenses until January overstates income while understating accounts payable. Therefore, audit procedures for liabilities should have as a primary objective the determination of the *completeness* of recorded payables.

Audit procedures for detecting understated liabilities differ from those used to detect overstated assets. Overstating an asset account usually requires an improper entry in the accounting records, as by the recording of a fictitious transaction. Such an improper entry can be detected by the auditors through verification of the individual entries making up the balance of an asset account. By way of contrast, understating a liability account is generally possible merely by *failing to make an entry* for a transaction creating a liability. The omission of an entry is less susceptible to detection than is a fictitious entry. If the omission is detected, it is much easier to pass it off as an accidental error. Auditors have long recognized that the most difficult type of fraud to detect is one based on the *nonrecording* of transactions.

When accounts payable entries have been recorded, the existence of a definite financial commitment makes accomplishment of the valuation audit objective less difficult than for assets (other than cash). The situation with accrued liabilities is different. As we suggested earlier, in many circumstances exact measurement of these accounts will be difficult; the auditors should audit management's accounting estimates.

Internal Control over Accounts Payable

LO 14-3

Identify and explain the fundamental controls over payables.

In thinking about internal control over accounts payable, it is important to recognize that the accounts payable of one company are the accounts receivable of other companies. It follows that there is little danger of errors being overlooked permanently because the client's creditors will generally maintain complete records of their receivables and will inform the client if payment is not received. This feature also aids auditors in the discovery of fraud because the perpetrator must be able to obtain and respond to the demands for payment. Some companies, therefore, may choose to minimize their record-keeping of liabilities and to rely on creditors to call attention to any delay in making payment. This viewpoint is not an endorsement of inaccurate or incomplete records of accounts payable, but merely a recognition that the self-interest of creditors constitutes an effective control in accounting for payables that is not present in the case of accounts receivable.

Discussions of internal control applicable to accounts payable may logically be extended to the entire purchase or acquisition cycle. In an effective purchasing system, a stores or inventory control department will prepare and approve the issuance of a purchase requisition that will be sent to the purchasing department. A copy of the purchase requisition will be filed numerically and matched with the subsequently prepared purchase order and finally with a copy of the receiving report.

The purchasing department, upon receiving the purchase requisition, will (1) determine that the item should be ordered and (2) select the appropriate vendor, quality, and price. Then, a serially numbered purchase order is issued to order the goods. Copies of the purchase order should be sent (either physically or electronically) to stores, receiving, and the accounts payable department. The copy sent to receiving is generally "blind" in that the quantities are not included in order to encourage counting of quantities by the receiving department. But the fact that a vendor's packing slip (with quantities) is almost always included when goods are received may decrease the effectiveness of this control.

The receiving department should be independent of the purchasing department. When goods are received, they should be counted and inspected. Receiving reports should be prepared for all goods received. These documents should be serially numbered and prepared in a sufficient number of copies to permit prompt notification of the receipt of goods to the stores department, the purchasing department, and the accounts payable department.



Illustrative Case

The Importance of Controls over Accounts Payable

The need for good IT system controls has become increasingly important as in recent years companies have downsized their accounts payable department. For example, *The Wall Street Journal* reports that General Electric Co., which processed in excess of 10 million invoices annually, reduced its accounts payable staff from approximately 400 employees to 180. Part of this reduction was made possible by a decision not to compare invoices with support prior to payment of vendors; payables were analyzed

only after the money had been disbursed. The article states that GE reduced payroll costs, but duplicate payments and overpayments to vendors increased.

Other companies have encountered similar situations. One corporate official suggests that unscrupulous vendors have become skilled in fooling computerized payables checking systems. He suggests that some vendors send two invoices with different numbers for the same item, and others add a letter to the end of an invoice number.

Within the accounts (vouchers) payable department, all forms should be stamped with the date received. **Vouchers** and other documents originating within the department can be controlled through the use of serial numbers. Each step in the verification of an invoice should be evidenced by entering a date and signature on the voucher. Comparison of the quantities listed on the invoice with those shown on the receiving report and purchase order prevents the payment of charges for goods in excess of those ordered and received. Comparison of the prices, discounts, and terms of shipment as shown on the purchase order and on the vendor's invoice provides a safeguard against the payment of excessive prices.

The separation of the function of invoice verification and approval from the function of cash disbursement is another step that tends to prevent errors and fraud. Before invoices are approved for payment, written evidence must be presented to show that all aspects of the transaction have been verified. The official who signs checks should stamp or perforate the voucher and supporting documents so that they cannot be presented to support payment a second time.

In an IT-based purchasing system, vendor invoice information is entered by the accounting department and may be matched by the IT system with other information. When goods are received, information may be keyed into the IT system with subsequent automated preparation of a receiving report and updating of inventory records. The IT system can match the information from purchase orders, receiving reports, and vendors' invoices and approve appropriate payments of accounts payable. Companies with IT-based systems should implement the controls described in Chapter 8 to ensure the accuracy of the systems input, processing, and output. As illustrated in the earlier illustrative case, *The Importance of Controls over Accounts Payable*, of particular concern is

STATEMENT			
Carson Supply Co.			
1671 21st St.			
Houston, TX 77021			
Customer:	Morris Construction Co.	June 30, 20X1	
	1212 Belaire Blvd.		
	Houston, TX 77062		
Date		Amount	Balance
June 1	Beginning balance		\$32,785.00
June 5	Invoice #3276485	\$ 5,250.00	38,035.00
June 9	Payment	–23,300.00	14,735.00
June 12	Credit #49944	–235.00	14,500.00
June 15	Invoice #3276678	10,220.00	24,720.00
June 26	Payment	–14,500.00	
June 30	Ending balance		\$10,220.00

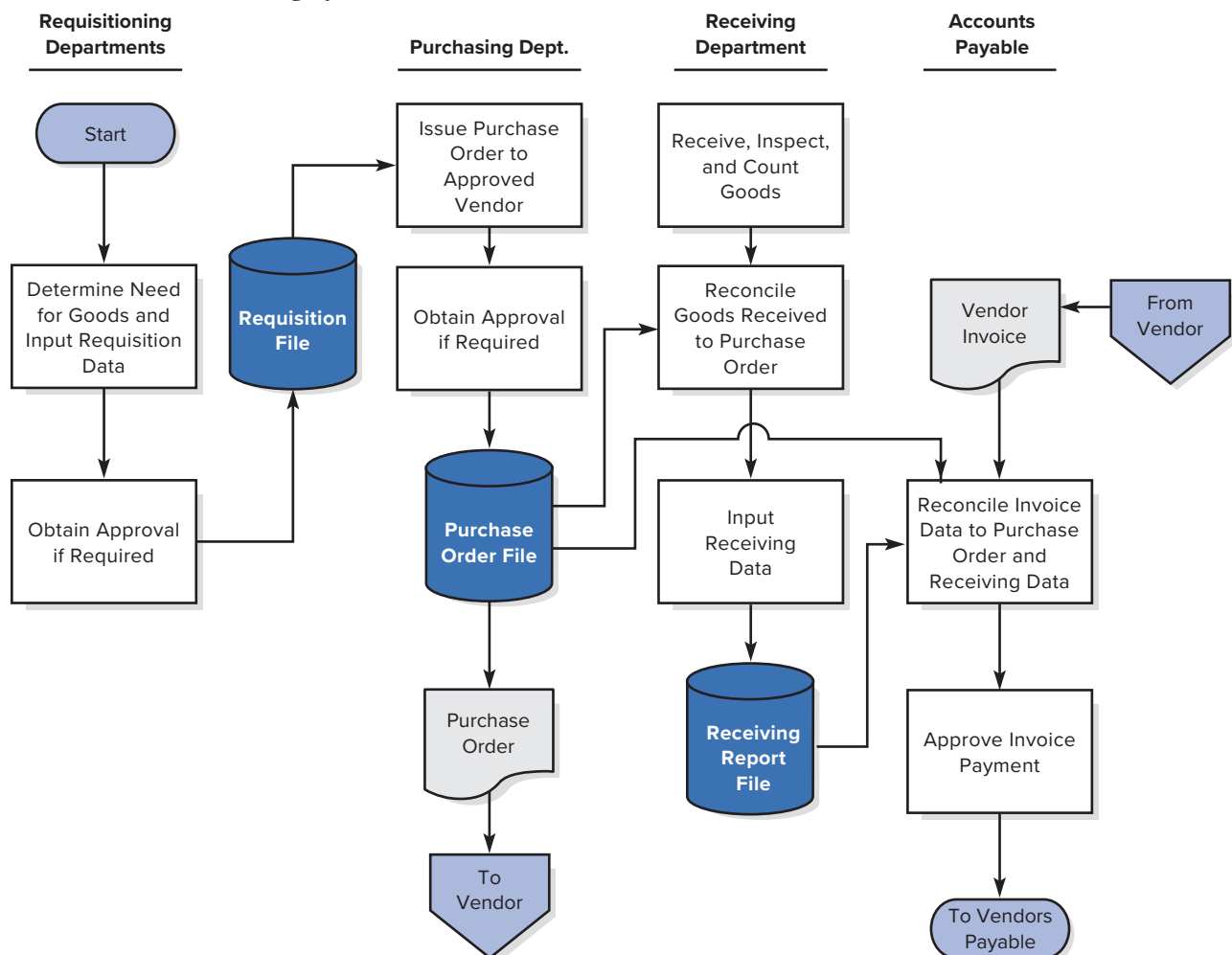
the possibility of paying invoice amounts twice because a smaller number of individuals examine documents in an IT-based system. Often, especially when invoices are not paid on a timely basis, a vendor will send a second invoice or statement requesting payment. Controls must be designed to prevent duplicate payments of invoices, especially those for payment of services such as retainer fees to attorneys. The company should ensure that its vendors have unique invoice numbering systems that do not allow a duplicate invoice to be issued under a different invoice number. Also, standard procedures should be established for inputting vendor identification and invoice numbers. For example, the procedures should describe how leading zeros should be handled in inputting invoice numbers. The company also may use software to detect potential duplicate payments by identifying those of identical amounts that have similar vendor identification or invoice numbers.

Another control that the auditors may expect to find in a well-managed accounts payable department is the monthly balancing of the detailed records of accounts payable (or vouchers) to the general ledger control account. These reconciliations should be preserved as evidence of the performance of this procedure and as an aid in locating any subsequent errors.

Vendors' statements, received monthly, should be reconciled promptly with the accounts payable ledger or list of open vouchers, and any discrepancies fully investigated. In some industries, it is common practice to make advances to vendors, which are recovered by making percentage deductions from invoices. When such advances are in use, the auditors should ascertain that procedures are followed to assure that deductions from the invoices are made in accordance with the agreement.

The operation of a purchase or acquisition transaction cycle is illustrated in Figure 14.1.

FIGURE 14.1 Purchasing Cycle



Audit Documentation for Accounts Payable

The principal working papers are a lead schedule for accounts payable, trial balances of the various types of accounts payable at the balance sheet date, and confirmation requests for accounts payable. The trial balances are often in the form of copies of client electronic files. In addition, the auditors may prepare a listing of *unrecorded* accounts payable discovered during the course of the audit, as illustrated later in Figure 14.6. The auditors also will document the controls and risk assessments for accounts payable.

Audit of Accounts Payable

The following steps indicate the general pattern of work performed by the auditors in the verification of accounts payable. Selection of the most appropriate procedures for a particular audit will be guided by the nature of the controls that have been implemented and by the results of the auditors' risk assessments.

- A. Use the understanding of the client and its environment to consider inherent risks, including fraud risks, related to accounts payable.
- B. Obtain an understanding of internal control over accounts payable.
- C. Assess the risks of material misstatement and design further audit procedures.
- D. Perform further audit procedures—tests of controls.
 1. Examples of tests of controls.
 - a. Test controls over the accounting records related to the accounts payable.
 - b. Test controls over processing purchase transactions.
 2. If necessary, revise the risks of material misstatement based on the results of tests of controls.
- E. Perform further audit procedures—substantive procedures for accounts payable.
 1. Obtain or prepare a trial balance of accounts payable as of the balance sheet date and reconcile with the general ledger.
 2. Vouch balances payable to selected creditors by inspection of supporting documents.
 3. Reconcile liabilities with monthly statements from creditors.
 4. Confirm accounts payable by direct correspondence with vendors.
 5. Perform analytical procedures or data analytics for accounts payable and related accounts.
 6. Search for unrecorded accounts payable.
 7. Perform procedures to identify accounts payable to related parties.
 8. Evaluate proper balance sheet presentation and disclosure of accounts payable.

Figure 14.2 relates the objectives of the major substantive tests of payables to the primary audit objectives.

A. Use the Understanding of the Client and Its Environment to Consider Inherent Risks, Including Fraud Risks, Related to Accounts Payable.

After they obtain an understanding of the client and its environment, the auditors are in a position to identify and assess inherent risks of accounts payable. Many of these risks arise from business risks faced by management, such as the risk of payment of unauthorized payables and the failure to capture all accounts payable for financial reporting purposes.

If any of the inherent risks identified by the auditors are related to fraud, the auditors will make certain that they understand the programs and controls established by management to control the risk. They also will determine that the controls have been implemented. Finally, the auditors will design appropriate responses to these fraud risks and all other risks of material misstatement.

LO 14-4

Use the understanding of the client and its environment to consider inherent risks (including fraud risks) related to accounts payable.

FIGURE 14.2
Objectives of Major
Substantive Procedures
for Accounts Payable

Substantive Procedures	Primary Audit Objectives
Obtain trial balance of payables and reconcile with the ledgers.	<i>Valuation and accuracy</i>
Vouch balances payable to selected creditors by inspecting supporting documents.	<i>Existence, occurrence, and obligations</i> <i>Valuation and accuracy</i> <i>Cutoff</i>
Reconcile liabilities with creditor's monthly statements. Confirm accounts payable. Perform analytical procedures or data analytics.	<i>Completeness</i> <i>Existence, occurrence, and obligations</i> <i>Valuation and accuracy</i> <i>Cutoff</i>
Search for unrecorded accounts payable.	<i>Completeness</i> <i>Cutoff</i>
Perform procedures to identify accounts payable to related parties. Evaluate financial statement presentation and disclosure.	<i>Presentation and disclosure</i>

LO 14-5

Obtain an understanding of internal control over accounts payable.



B. Obtain an Understanding of Internal Control over Accounts Payable.

One approach used by auditors in becoming familiar with a client's internal control over accounts payable is to prepare a flowchart or to use flowcharts prepared by the client. In some engagements, the auditors may choose to prepare a narrative description covering such matters as the independence of the accounts payable department and the receiving department from the purchasing department. The auditors also might use a questionnaire to obtain a description of accounts payable controls. Typical of the questions are the following: Is an accounts payable trial balance prepared monthly and reconciled to the general ledger controlling account? Are monthly statements from vendors reconciled with accounts payable ledgers or unpaid vouchers? Are advance payments to vendors recorded as receivables and controlled in a manner that assures that they will be recovered by offset against vendors' invoices? Are debit memos issued to vendors for discrepancies in invoice prices, quantities, or computations? Are debit balances in vendors' accounts brought to the attention of the credit and purchasing departments?

After the auditors have prepared a flowchart (or other description) of internal control, they determine whether the client is actually using the controls described to them; that is, they determine whether the controls have been implemented. The auditors will typically perform a walk-through of several purchase transactions and observe the implementation of the various controls. Figure 14.3 illustrates the documents and accounts that the auditors typically encounter in their consideration of controls over purchase transactions.

As the auditors verify their understanding of internal control, they will observe and inquire about the segregation of duties for purchases and cash disbursements. They also will inspect the various documents and reconciliations that are important to the client's internal control over accounts payable. For example, the reconciliations of monthly statements from vendors to the payables ledger will be inspected. Budgets for cash disbursements will be inspected and the auditors will review the evidence of the follow-up on variances from budgeted amounts of disbursements. These procedures may serve as tests of controls that provide the auditors with sufficient evidence to assess control risk for certain financial statement assertions about accounts payable as being at less than the maximum.

C. Assess the Risks of Material Misstatement and Design Further Audit Procedures.

After considering the information about the client and its environment, including internal control over accounts payable, the auditors identify and assess the risks of material misstatement at the financial statement and assertion levels. At the financial statement level,

FIGURE 14.3 Overview of the Purchases Cycle—Documents and Accounts**Purchases**

Morris Construction Co. Purchase Requisition		Morris Construction Co. Receiving Report	
1000985		5874983	
Department: <u>General Stores</u>	Date: <u>May 10, 20X0</u> Date Required: <u>June 15, 20X0</u>	Received From: <u>Carson Supply Co.</u> <u>1671 21st St.</u> <u>Houston, TX 77021</u>	Date: <u>May 30, 20X0</u> Order No: <u>AA09847</u> Carrier: <u>SOS Delivery</u>
Quantity	Description	Quantity	Description
250	Acme chrome faucets #278473	250	Acme chrome faucets #278473
Approved By: <u>Don Warren</u>		Received By: <u>Bill Jones</u>	

AA09847

PURCHASE ORDER
Morris Construction Co.
1212 Belaire Blvd.
Houston, TX 77062

To: Carson Supply Co. Date: May 12, 20X0
1671 21st St.
Houston, TX 77021 Ship via: SOS Delivery

Terms: 2/10. n/30

Enter our order for

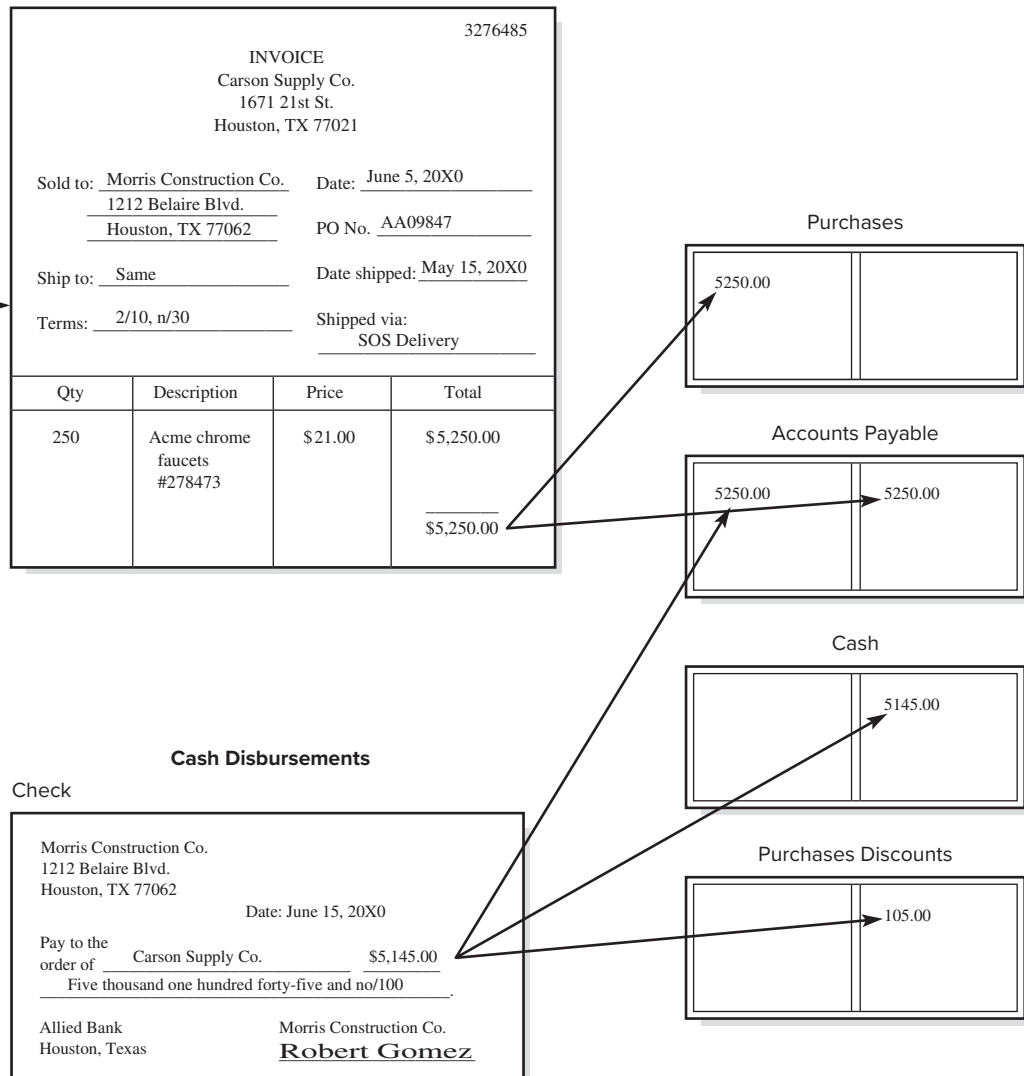
Qty	Description	Price	Total
250	Acme chrome faucets #278473	\$21.00	\$5,250.00

Morris Construction Co.
By: Mary Goyer

↑

they assess whether identified risks have (1) a pervasive effect on the financial statements and require an overall response and (2) effects on individual financial statement assertions. At the assertion level, the auditors identify relevant assertions, and design appropriate further audit procedures in response. If additional evidence of effectiveness of the controls is needed to support these assessed levels, the auditors will design additional tests of control. In designing these tests, the auditors must decide which ones will result in sufficient reductions in substantive procedures to justify the time spent performing them. This entire process is described in detail in Chapter 6.

Figure 14.4 provides examples of potential misstatements and weaknesses in internal control over accounts payable.



D. Perform Further Audit Procedures—Tests of Controls.

Tests directed toward the effectiveness of controls help to evaluate the client's internal control and determine whether the auditors can support their planned assessed levels of the risks of material misstatement for the assertions about accounts payable. A number of tests of controls relating to accounts payable have already been discussed in Chapters 10 and 12. In this chapter, we briefly recap several significant tests.

1. Examples of Tests of Controls.

a. Test controls over the accounting records related to the accounts payable.

The validity of the amount in the general ledger control account for accounts payable may be established by tracing postings to the **voucher register** and cash disbursements journal. This work may be performed before the balance sheet date as part of a general test of postings to all records. At the same time, the auditors should scrutinize all entries to the control account for the entire period under audit and should investigate any unusual entries.

In an IT system with effective controls, this objective may be achieved by testing the application controls.

FIGURE 14.4 Potential Misstatements—Accounts Payable

Description of Misstatement	Examples	Internal Control Weaknesses or Factors That Increase the Risk of the Misstatement
Inaccurate recording of a purchase or disbursement	Fraud: - A bookkeeper prepares a check to himself and records it as having been issued to a major supplier. Error: - A disbursement is made to pay an invoice for goods that have not been received.	- Inadequate segregation of duties of record-keeping and preparing cash disbursements, or check signer does not review and cancel supporting documents - Ineffective controls for matching invoices with receiving documents before disbursements are authorized
Misappropriation of purchases	Fraud: Goods are ordered but delivered to an inappropriate address and stolen.	Ineffective controls for matching invoices with receiving documents before disbursements are authorized
Duplicate recording of purchases	Error: A purchase is recorded when an invoice is received from a vendor and recorded again when a duplicate invoice is sent by the vendor.	Ineffective controls for review and cancelation of supporting documents by the check signer
Late (early) recording of cost of purchases—"cutoff problems"	Fraud: Purchases journal "closed early" with this period's purchases recorded as having occurred in subsequent period.	Ineffective board of directors, audit committee, or internal audit function; "tone at the top" not conducive to ethical conduct; undue pressure to meet earnings target

b. Test controls over processing purchase transactions.

The manner in which the auditors test the controls over processing purchase transactions depends on the nature of the client's system and the related controls. In a less sophisticated system, the auditors may decide to test the controls by vouching specific items back through the purchases journal and the cash payments journal to original documents (such as purchase orders, receiving reports, invoices, and paid checks). If the functions of purchasing, receiving, invoice verification, and cash disbursement are delegated to separate departments and controls are tested and found to be operating effectively, the vouching of individual items from the ledgers to the original records may provide the auditors with sufficient evidence to assess control risk for certain assertions (e.g., existence) related to accounts payable as being at a low level.

The auditors also may perform tests by following the audit trail in the opposite direction. By tracing a representative sample of entries from the source documents to the accounts payable ledger, the auditors can verify that accounts payable are completely and accurately recorded on a timely basis.

When the client has a more sophisticated IT system, the auditors may find it more efficient to test the application controls rather than to test a sample of purchase transactions. Batch processing controls might be tested by inspecting evidence of the reconciliations of batch control totals by the control group. In addition, a sample of the exception reports printed by the computer when the vendors' invoices do not match purchasing and receiving information might be inspected, as well as evidence of follow-up on these exceptions. Data analytics may be used to determine that all purchase/accounts payable transactions are authorized and supported with appropriate documentation, including applicable receiving documents.

LO 14-6

Assess the risks of material misstatement of accounts payable and design further audit procedures, including tests of controls and substantive procedures, to address the risks.

2. If Necessary, Revise the Risks of Material Misstatement Based on the Results of Tests of Controls.

Completion of the preceding audit procedures enables the auditors to perform a final assessment of the risk of material misstatement for each of the major financial statement assertions about accounts payable. The auditors use the reassessment of control risk to determine whether it is necessary to modify their planned substantive procedures.

An assessment of low control risk for accounts payable often means that the auditors have found that serially numbered receiving reports are prepared promptly by the client for all goods received, that serially numbered vouchers are prepared and recorded in the voucher register, and that payments are made promptly on the due dates and immediately recorded in the cash payments journal and accounts payable subsidiary ledger. Finally, at the end of each month, an employee who does not participate in processing accounts payable compares the individual accounts in the accounts payable subsidiary ledger with vendors' statements and also compares the total of the subsidiary record with the general ledger control account. This strong internal control would enable the auditors to minimize substantive procedures for accounts payable.

On the other hand, an assessment of high control risk for accounts payable often means that the auditors have found that the subsidiary record of accounts payable is not in agreement with the general ledger control account, that receiving reports and vouchers are used haphazardly, that purchase transactions often are not recorded until payment is made, and that many accounts payable are long past due. In this situation, the auditors should undertake extensive substantive work to address the completeness of liabilities at the balance sheet date.

E. Perform Further Audit Procedures—Substantive Procedures for Accounts Payable.

1. Obtain or Prepare a Trial Balance of Accounts Payable as of the Balance Sheet Date and Reconcile with the General Ledger.

One purpose of this procedure is to determine that the liability figure appearing in the balance sheet is in agreement with the individual items comprising the detailed records. A second purpose is to provide a starting point for substantive procedures. The auditors will use the list of vouchers or accounts payable to select a representative group of items for careful examination.

The client company usually furnishes the auditors with a year-end trial balance. The auditors should verify the footing and the accuracy of individual amounts in the trial balance, generally using an electronic spreadsheet. If the schedule of individual items does not agree in total with the control account, the cause of the discrepancy should be investigated. In most situations, the auditors will arrange for the client's staff to locate such errors and make the necessary adjustments. Agreement of the control account and the list of individual account balances is not absolute proof of the total indebtedness; invoices received near the close of the period may not be reflected in either the control account or the subsidiary records, and other similar errors may exist without causing the accounts to be out of balance.

2. Vouch Balances Payable to Selected Creditors by Inspection of Supporting Documents.

In situations in which there is a risk of inaccurate recording of transactions, the auditors should consider vouching selected creditors' balances to supporting vouchers, invoices, purchase orders, and receiving reports. For companies that use a voucher system, the unpaid vouchers at year-end represent the liability account. Electronic systems are generally able to generate such year-end data at any point on or after year-end. For systems that lack this capability, particularly manual systems, the verification of the individual vouchers often is made most conveniently at the balance sheet date, when the vouchers will be together in the unpaid voucher file. The content of the unpaid voucher file changes daily; as vouchers are paid, they are removed from the file and filed alphabetically by vendor. Consequently, it is important for such systems that the client maintain a list of year-end unpaid vouchers. This listing should show the names of vendors, voucher numbers, dates, and amounts.

Primary Audit Objectives:	
Valuation	☒
Accuracy	☒

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Obligations	☒
Valuation	☒
Accuracy	☒
Cutoff	☒

Primary Audit Objectives:	
Completeness	☒
Obligations	☒
Valuation	☒
Accuracy	☒
Cutoff	☒

Primary Audit Objectives:	
Completeness	☒
Existence	☒
Occurrence	☒
Obligations	☒
Valuation	☒
Accuracy	☒
Cutoff	☒

Primary Audit Objectives:	
Completeness	☒
Obligations	☒
Valuation	☒
Accuracy	☒
Cutoff	☒

3. Reconcile Liabilities with Monthly Statements from Creditors.

In some companies, it is a regular practice each month to reconcile vendors' statements with the detailed records of payables. If the auditors find that the client's staff regularly performs this reconciliation, they may limit their review of vendors' statements to determining that the reconciliation work has been satisfactory.

If the client's staff has not reconciled vendors' statements and accounts payable, the auditors may do so on a selected basis. When the risk of material misstatement for accounts payable is high, the auditors may control incoming mail to assure that all vendors' statements received by the client are made available to the auditors. Among the discrepancies often revealed by reconciliation of vendors' statements are charges by the vendor for shipments not yet received or recorded by the client. Although, conceptually, all goods on which title has passed should be included in inventory (thus, items shipped FOB [free on board] shipping point as of year-end and not yet received should be included), normal accounting procedures often do not provide for recording invoices as liabilities until the merchandise has been received. In-transit shipments on which title has passed should be listed and a decision reached as to whether they are sufficiently material to warrant year-end adjustment.

4. Confirm Accounts Payable by Direct Correspondence with Vendors.

Although **confirmation** of accounts payable is a widely used procedure, it is generally considered less necessary than is the confirmation of accounts receivable. One reason is that for accounts payable, the auditors will find in the client's possession externally created evidence such as vendors' invoices and statements that substantiate the accounts payable. Generally only limited external evidence (e.g., the customer's purchase order) is on hand to support accounts receivable.

Another reason for the difference in significance attached to confirmation of accounts payable is that the greatest risk in the audit of liabilities is the possibility of unrecorded amounts. While confirmation can provide evidence about completeness, it is a more effective procedure for establishing existence and valuation of an item. To make the confirmation procedure more effective at addressing the completeness of accounts payable, the auditors will often use a *blank form*, as illustrated by Figure 14.5. This form asks the vendor to fill in the amount of the liability rather than to confirm a recorded amount.

Also, accounts payable confirmation requests should be sent to vendors from whom substantial purchases have been made during the year, regardless of the size of their accounts at the balance sheet date (even to suppliers whose accounts show *zero balances*). These substantial suppliers may be identified by reference to cash disbursement records or computer printouts of purchase volume by individual supplier, inquiry of purchasing department personnel, and examination of the accounts payable subsidiary ledger. Other accounts that often are confirmed by the auditors include those for which monthly statements are not available, accounts reflecting unusual transactions, accounts with parent or subsidiary corporations, and accounts secured by pledged assets.

5. Perform Analytical Procedures or Data Analytics for Accounts Payable and Related Accounts.

To gain assurance as to the overall reasonableness of accounts payable, the auditor may compute ratios such as purchases divided by accounts payable and accounts payable divided by total current liabilities. These ratios are compared with ratios for prior years to disclose trends that warrant investigation.

The list of amounts payable to individual vendors should be reviewed to identify any companies from which the client does not ordinarily acquire goods or services. The amounts owed to individual creditors also should be compared with balances in prior years. By studying yearly variations in purchases and other accounts closely related to accounts payable, the auditors may become aware of errors in accounts payable. Finally, the portion of accounts payable that is past due at year-end should be compared with corresponding data for previous years.

The auditors may test purchase discounts by computing the ratio of cash discounts earned to total purchases during the period and comparing this ratio from period to

FIGURE 14.5
Accounts Payable
Confirmation

PACKAGE SYSTEMS, INC. 9200 CHANNEL STREET NEW ORLEANS, LOUISIANA 70128	
Grayline Container, Inc. 4800 Madison Street Dallas, Texas 75221 Dear Sirs: Our independent auditors, Nelson & Gray, CPAs, are performing an audit of our financial statements. For this reason, please inform them in the space provided below the amount, if any, owed to you by this company at December 31, 20X1. Please attach an itemized statement supporting any balance owed, showing all unpaid items. Your reply should be sent directly to Nelson & Gray, CPAs, 6500 Lane Avenue, New Orleans, Louisiana 70128. A stamped, addressed envelope is enclosed for your reply. Thank you. Sincerely, Robert W. James Robert W. James Controller	January 2, 20X2
----- Nelson & Gray, CPAs Our records show that the amount of \$ <u>26,800</u> was owed to us by Package Systems, Inc., at December 31, 20X1, as shown by the itemized statement attached. Date: <u>Jan. 6, 20X2</u> Signature <u>Sharon Steele</u> Title <u>Controller</u>	

period. Any significant decrease in the ratio might indicate a change in terms of purchases, failure to take discounts, or fraudulent manipulation.

Many of the above procedures may be performed using data analytics software. As an example, the auditors may compare vendors on the list of accounts payable to the file of approved vendors. They also may search for accounts payable for purchases of goods that do not have evidence of receipt of the goods.

6. Search for Unrecorded Accounts Payable.

Throughout the audit, the auditors should be alert for any unrecorded payables. For example, the preceding three steps of this plan—reconciliation, confirmation, and analytical procedures—may disclose unrecorded liabilities. In addition to normal trade payables that may be unrecorded, other examples include unrecorded liabilities related to customers' deposits recorded as credits to accounts receivable, obligation for securities purchased but not settled at the balance sheet date, unbilled contractor or architect fees for a building under construction at the audit date, and unpaid attorney or insurance broker fees.

Primary Audit Objectives:	
Completeness	☒
Cutoff	☒

In addition to the prior audit steps, when searching for unrecorded accounts payable, the auditors will examine transactions that were recorded following year-end. A comparison of cash payments occurring after the balance sheet date with the accounts payable trial balance is generally the most effective means of disclosing unrecorded accounts payable. All liabilities must eventually be paid and will, therefore, be reflected in the accounts at least by the time they are paid. Regular monthly expenses, such as rent and utilities, are often posted to the ledger accounts directly from the cash disbursements journal without any account payable or other liability having been set up. Therefore, the auditors will often examine all cash disbursements over specific dollar amounts that are made by the client during the **subsequent period**. The auditors might also use data analytics to more precisely identify disbursements that are more likely to represent payments for unrecorded liabilities.

The auditors also should consider potential sources of unrecorded payables such as the following:

- a. Unmatched invoices and unbilled receiving reports. These documents are called *work in process* in a voucher system. The auditors should review such unprocessed documents at the balance sheet date to ascertain that the client has recorded an account payable where appropriate.
- b. Vouchers payable entered in the voucher register subsequent to the balance sheet date. Inspection of these records may uncover an item that should have been recorded as of the balance sheet date.
- c. Invoices received by the client after the balance sheet date. Not all vendors send invoices promptly when goods are shipped or services are rendered. Accordingly, the auditors' review of invoices received by the client in the subsequent period may disclose unrecorded accounts payable as of the balance sheet date.
- d. **Consignments** in which the client acts as a consignee. The consignee assumes liability for consigned merchandise when those goods have been sold to third parties. Those sales, especially shortly before the year-end, may not have been set up as a liability to the consignor. While the auditors' overall knowledge about the accounting for such consigned items will dictate the appropriate procedures, those related to the revenue cycle, such as tests of sales transactions around year-end, may reveal such sales.

A form of audit working paper used to summarize unrecorded accounts payable discovered by the auditors is illustrated in Figure 14.6.

When the auditors discover unrecorded liabilities, the next question is whether the omissions are sufficiently material to warrant proposing an adjusting entry. Will the adjustment cause a sufficient change in the financial statements to give a different impression of the company's current position or of its earning power? As previously indicated in the discussion of the reconciliation of vendors' statements with accounts payable, auditors may choose not to propose adjustments for the purpose of adding shipments in transit to the year-end inventory unless the shipments are unusually large.

As a further illustration of the factors to be considered in deciding upon the *materiality* of an unrecorded transaction, let us use as an example the December 31 annual audit of a small manufacturing company in good financial condition with total assets of \$3 million and preadjustment net income of \$100,000. The auditors' procedures led to the detection of the following unrecorded liabilities:

- a. An invoice of \$1,400, dated December 30 and bearing terms of FOB shipping point. The goods were shipped on December 30 but were not received until January 4. The invoice was also received and recorded on January 4.

In considering the materiality of this omission, the first point is that net income is not affected. The adjusting entry, if made, would add equal amounts to current assets (inventories) and to current liabilities; hence, it would not change the amount of working capital. The omission does affect the current ratio very slightly. The auditor would probably consider this transaction as not sufficiently material to warrant adjustment.

- b. Another invoice for \$4,000, dated December 30 and bearing terms of FOB shipping point. The goods arrived on December 31 and were included in the physical inventory

FIGURE 14.6 Search for Unrecorded Liabilities

THE PALERNO COMPANY Unrecorded Accounts Payable December 31, 20X3				M-11 LK 2/19/X4
Date	Invoice Number	Vendor and Description	Account Charged	Amount
12/31/X3	2581	Hayes Mfg. Co.—invoice and shipment in transit	Inventories	\$10,650.00
12/31/X3	2428	Tax & Williams—unpaid legal fees—see M-4	Legal Expenses	1,000.00
12/31/X3	-	Allen Enterprises—12/19 account sales for consigned goods	Sales	25,680.00
-	-	Hart & Co.—machinery repairs (paid 1/1/X4)	Repairs Expense	12,600.00
-	-	Grant Co.—shipment received 12/31/X3 per receiving report no. 2907; invoice not yet received	Cost of Sales	15,820.00
-	-	Arthur & Baker—earned but unpaid architects' fee for building under construction—see K-5	Construction in Progress	23,370.00
				<u>\$89,120.00</u>

A.J.E. #8	131 Inventories		10,650.00	
	501 Cost of Sales		15,820.00	
	156 Construction in Progress		23,370.00	
	401 Sales		25,680.00	
	518 Legal Expenses		1,000.00	
	527 Repairs Expense		12,600.00	
	203 Accounts Payable			89,120.00
To record unrecorded accounts payable at 12/31/X3				
The above payables were identified principally in the audit of accounts payable. See audit plan B-4 for procedures employed. In my opinion the \$89,120 adjustment includes all material unrecorded accounts payable.				
				LK 2/23/X4

taken that day. The invoice was not received until January 8 and was entered as a January transaction.

This error should be corrected because the inclusion of the goods in the physical inventory without recognition of the liability has caused an error of \$4,000 in pretax income for the year. Because the current liabilities are understated, both the amount of working capital and the current ratio are overstated. The owners' equity is also overstated. These facts point to the materiality of the omission and constitute strong arguments for an adjusting entry.

- c. An invoice for \$1,500, dated December 31, for a new office safe. The safe was installed on December 31, but the invoice was not recorded until paid on January 15.

Because the transaction involves only asset and liability accounts, the omission of an entry does not affect net income. However, working capital and the current ratio are affected by the error because the debit affects a noncurrent asset and the credit affects a current liability. Most auditors would probably not propose an adjusting entry for this item.

- d. An invoice for \$3,000, dated December 31, for advertising services rendered during October, November, and December. The invoice was not recorded until paid on January 15.

The argument for treating this item as sufficiently material to warrant adjustment is based on the fact that net income is affected, as well as the amount of working capital and the current ratio. The adjusting entry should probably be recommended in these circumstances.

The preceding examples suggest that a decision as to the materiality of an unrecorded transaction hinges to an important extent on whether the transaction affects net income. Assuming that an omitted transaction *does* affect net income and there is doubt as to whether the dollar amount is large enough to warrant adjustment, the auditors should bear in mind that about one-third of the effect of the error on net income may be eliminated by corporate income taxes. In other words, an adjusting entry to record an omitted expense item of \$10,000 may reduce after-tax income by only \$6,500. If the adjusting entry is not made, the only ultimate effect is a shift of \$6,500 between the net incomes of two successive years. Unless the client requests all adjusting entries, the auditors should avoid proposing adjusting entries for clearly inconsequential errors in the year-end cutoff of transactions. However, it should be borne in mind that a number of insignificant individual misstatements may be material in their *cumulative* effect on the financial statements. Therefore, the auditors will accumulate the effects of the adjusting entries not proposed (passed) to consider them with misstatements detected in other accounts, as discussed in Chapter 16.

Primary Audit Objective:
Presentation ☒

7. Perform Procedures to Identify Accounts Payable to Related Parties.

Payables to a corporation's officers, directors, stockholders, or affiliates require particular attention by the auditors because they are not the result of arm's-length bargaining by parties of opposing interests. Here the auditors should consider the possibility that these payables relate to purchases of inventory or other asset items for which there may be valuation questions.

The independent auditors should search for such payables either manually or through the use of data analytics software. All material payables to related parties must be disclosed in the financial statements.

Primary Audit Objective:
Presentation ☒

8. Evaluate Proper Balance Sheet Presentation and Disclosure of Accounts Payable.

Proper balance sheet presentation of accounts payable requires that any material amounts payable to related parties (directors, principal stockholders, officers, and employees) be listed separately from amounts payable to trade creditors.

Debit balances of substantial amount sometimes occur in accounts payable because of such events as duplicate payments made in error, return of merchandise to vendors after payment has been made, and advances to suppliers. If these debit balances are material, a reclassification entry should be made in the audit working papers so that the debit balances will appear as assets in the balance sheet rather than being offset against other accounts payable with credit balances.

If the client company acts as a consignee of merchandise, it is possible that sales of consigned goods shortly before the year-end may not have been set up as a liability to the consignor. An accurate determination of any amounts owing to consignors at the balance sheet date is one step in the proper balance sheet presentation of liabilities.

Accounts payable secured by pledged assets should be disclosed in the balance sheet (or a note thereto) and cross-referenced to the pledged assets.

Other Liabilities

Notes payable are discussed in the next chapter. In addition to the accounts payable previously considered, other items classified as current liabilities include

1. Amounts withheld from employees' pay.
2. Sales taxes payable.
3. Unclaimed wages.
4. Customers' deposits.
5. Accrued liabilities.

**Amounts Withheld
from Employees'
Pay**

Payroll deductions are numerous; among the more important are Social Security taxes and individual income taxes. Although the federal and state governments do not specify the exact form of records to be maintained, they do require that records of amounts earned and withheld be adequate to permit a determination of compliance with tax laws.

Income taxes withheld from employees' pay and not remitted as of the balance sheet date constitute a liability to be verified by the auditors. Accrued employer payroll taxes may be audited at the same time. This verification usually consists of tracing the amounts withheld to the payroll summary sheets, testing computations of taxes withheld and accrued, determining that taxes have been deposited or paid in accordance with federal and state laws and regulations, and reviewing quarterly tax returns.

Payroll deductions also are often made for union dues, charitable contributions, retirement plans, insurance, savings bonds, and other purposes. Besides verifying the liability for any such amounts withheld from employees and not remitted as of the balance sheet date, the auditors should review the adequacy of the withholding procedures and determine that payroll deductions have been properly authorized and accurately computed.

**Sales Taxes
Payable**

In most sections of the United States, business concerns involved in retail sales are required to collect sales taxes imposed by state and local governments. These taxes do not represent an expense to the business; the retailer merely acts as a collecting agent. Until the amounts collected from customers are remitted to the taxing authority, they constitute current liabilities of the business. The auditors' verification of this liability includes a review of the client's periodic tax returns. The reasonableness of the liability also is tested by a computation applying the tax rate to total taxable sales. In addition, the auditors should examine a number of sales invoices to ascertain that customers are being charged the correct amount of tax. Debits to the liability account for remittances to the taxing authority should be traced to copies of the tax returns and vouched to the paid checks.

Unclaimed Wages

Unclaimed wages are, by their very nature, subject to misappropriation. The auditors, therefore, are concerned with the adequacy of internal control over this item. A list of unpaid wages should be prepared after each payroll distribution. The payroll checks should not be left for more than a few days in the payroll department. Prompt deposit in a special bank account provides much improved control. The auditors will analyze the Unclaimed Wages account for the purpose of determining that (1) the credits represent all unclaimed wages after each payroll distribution and (2) the debits represent only authorized payments to employees, remittances to the state under unclaimed property laws, or transfers back to general cash funds through approved procedures.

**Customers'
Deposits**

Many companies require that customers make deposits on returnable containers. Public utilities and common carriers also may require deposits to guarantee payment of bills or to cover equipment on loan to the customer. A review of the procedures followed in accepting and returning deposits should be made by the auditors with a view to disclosing any shortcomings in internal control. In some instances, deposits shown by the records as refunded to customers may in fact have been abstracted by employees.

The verification should include obtaining a list of the individual deposits and a comparison of the total with the general ledger control account. If deposits are interest-bearing, the amount of accrued interest also should be tested for reasonableness. As a general rule, the auditors do not attempt to confirm deposits by direct communication with customers; however, this procedure is desirable if the amounts involved are substantial or controls are considered to be deficient.

Accrued Liabilities

Most accrued liabilities (expenses) represent obligations payable sometime during the succeeding period for services or privileges received before the balance sheet date. Examples include interest payable, accrued property taxes, accrued payrolls and payroll taxes, income taxes payable, and amounts accrued under service guarantees.

Accrued liabilities represent accounting estimates made by the client of amounts that will subsequently become payable. Recall from Chapter 5 that, in evaluating the reasonableness of accounting estimates, auditors use one or more of the following three basic approaches:

1. Review and test management's process of developing the estimate.
2. Review subsequent events or transactions bearing on the estimate.
3. Independently develop an estimate of the amount to compare to management's estimate.

For most accrued liabilities, the audit approach will emphasize a review and test of management's process of developing the estimates (see particularly audit plan steps 1 through 5 below).

Issues such as management's estimates (1) being based on highly subjective assumptions and (2) often made through manual computations may make it difficult to establish control over accrued liabilities. As a result, these estimates may be particularly susceptible to misstatement, especially in circumstances in which management is under pressure to show increased earnings.

The basic auditing steps for accrued liabilities are

1. Examine any contracts or other documents on hand that provide the basis for the accrual.
2. Appraise the accuracy of the detailed accounting records maintained for this category of liability.
3. Identify and evaluate the reasonableness of the assumptions made that underlie the computation of the liability.
4. Test the computations made by the client in setting up the accrual.
5. Determine that accrued liabilities have been treated consistently at the beginning and end of the period.
6. Consider the need for accrual of other accrued liabilities not presently considered (that is, test completeness).
7. For significant estimates, perform a retrospective analysis of the prior year's estimates for evidence of management bias.

The following sections describe the nature of the audit of various accrued liabilities.

Accrued Property Taxes

Property tax payments are usually few in number and substantial in amount. It is, therefore, feasible for the audit working papers to include an analysis showing all of the year's property tax transactions. Tax payments should be verified by inspection of the property tax bills issued by local government units and by reference to the related paid checks. If the tax accruals at the balance sheet date differ significantly from those of prior years, an explanation of the variation should be obtained. The auditors should verify that property tax bills have been received on all taxable property or that an estimated tax has been accrued.

Accrued Payrolls

The audit of payrolls from the standpoint of appraising the adequacy of controls and substantiating the expenditures for the period under audit is considered in Chapter 16. The present consideration of payrolls is limited to the procedures required for testing accrued payrolls at the balance sheet date.

Accrued gross salaries and wages appear on the balance sheets of virtually all concerns. The accuracy of the amount accrued may be significant in the determination of total liabilities and also in the proper matching of costs and revenue. The verification procedure consists principally of comparing the amounts accrued to the actual payroll of the subsequent period and reviewing the method of allocation at the balance sheet date. Payments made at the first payroll dates of the subsequent period are reviewed to determine that no significant *unrecorded* payroll liability existed as of the balance sheet date.

Pension Plan Accruals

Auditing procedures for the accrued liability for pension costs may begin with a review of the copy of the pension plan in the auditors' permanent file. Then consideration should be given to the provisions of the Employee Retirement Income Security Act (ERISA). The auditors should determine that the client's accrued pension liability is presented in accordance with FASB ASC 715, including consideration of service cost, interest cost, amortization of transition and service costs, and gains and losses on pension plan assets. In auditing these amounts, the auditors will obtain representations from an actuary and confirm the activity in the plan with the trustee. In evaluating the evidence from the actuary, the auditors should comply with the requirements of AICPA AU-C 620 and PCAOB AS 1210 for using the work of a specialist, as discussed in Chapter 5.

Postemployment Benefits Other Than Pensions

Under FASB ASC 715, companies must accrue, during the years that employees perform services, the expected cost of providing health and similar retirement benefits to the employees, their beneficiaries, and their dependents. Determining the amount of these liabilities is a very complex procedure because assumptions must be made about matters such as employee work lives and increases in medical costs. Because actuaries and other specialists develop these assumptions, the auditors should evaluate the assumptions and the specialists' qualifications in accordance with AICPA AU-C 620 and PCAOB AS 1210.

Accrued Vacation Pay

Closely related to accrued salaries and wages is the liability that may exist for accrued vacation pay. This type of liability arises from two situations: (1) An employee entitled by contract to a vacation during the past year may have been prevented from taking it by an emergency work schedule and (2) an employee may be entitled to a future vacation of which part of the cost must be accrued to achieve a proper matching of costs and revenue.

The auditors' verification of accrued vacation pay may begin with a review of the permanent file copy of the employment contract or agreement stipulating vacation terms. The computation of the accrual should then be verified both as to arithmetical accuracy and for agreement with the terms of the company's vacation policy.

Product Warranty Liabilities

The products of many companies are sold with a guarantee of free service or replacement during a rather extended warranty period. The costs of rendering such services should be recognized as expenses in the year the product is sold rather than in a later year in which the replacement is made or the repair service is performed. If this policy is followed, the company will make an annual charge to expense and a credit to a liability account based on the amount of the year's sales and the estimated future service or replacement cost. As repairs and replacements take place, the costs will be charged to the liability account.

The auditors should review the client's annual provision for estimated future expenditures and compute the percentage relationship between the amount in the liability account and the amount of the year's sales. If this relationship varies sharply from year to year, the client should be asked for an explanation. The auditors also should review the charges to the liability account month by month and be alert for the improper recording of other expenses in this account. Sudden variations in the monthly charges to the liability account require investigation. In general, the auditors should determine that the balance in the liability account for service guarantees moves in reasonable relationship with the trend of sales. The auditors also should be alert for changes in the client's products or repair costs that might affect the amount of the warranty liability.

Current income tax laws prohibit the deduction of provisions for warranty liabilities; deductions are permitted only when actual expenditures are incurred. Accordingly, the auditors should ascertain that the client is properly allocating income taxes attributable to the nondeductible provisions.

Accrued Commissions and Bonuses

Accrued commissions to sales representatives and bonuses payable to managerial personnel also require verification. The essential step in this case is reference to the authority for the commission or bonus. The basic contracts should be examined and traced to minutes of directors' meetings. If the bonus or commission is based on the total volume of sales or some other objective measure, the auditors should verify the computation of the accrual by applying the prescribed rate to the amount used as a base.

Focus on the Airline Industry

The frequent flyer travel award programs in the airline industry are similar to product warranty liabilities in the sense that a free service is associated with the purchase of airline tickets. These programs provide an excellent example of the accounting and auditing difficulties involved with many accrued liabilities. In these programs, travelers earn frequent flier mileage for flying with the airline, which may be exchanged for flight awards.

In accounting for these programs, estimates must be made of the percentage of the mileage that will ultimately be redeemed as well as the expected cost of providing the travel. Currently, airlines account for the awards by the incremental cost method, which calculates the airline's liability as the incremental cost associated with transporting a passenger in an otherwise empty seat. While auditors may easily test computations and determine that the liability has been treated consistently at the beginning and end of the period, determining the reasonableness of the estimates of redemption rates and future costs is more difficult. Generally, they must use analytical procedures that focus on the prior experience of the client and other airline companies.

Income Taxes Payable

Federal, state, and foreign income taxes on corporations represent a material factor in determining both net income and financial position. The auditors cannot express an opinion on either the balance sheet or income statement of a corporation without first obtaining evidence that the provision for income taxes has been properly computed. In the audit of small and medium-size companies, it is customary for the audit engagement to include the preparation of the client's tax returns. If the client's staff or other persons have prepared the income tax returns, the auditors should nevertheless verify the reasonableness of the tax liability if they are to express an opinion on the fairness of the financial statements. In performing such a review of a tax return prepared by the client's staff or by others, the auditors may sometimes discover an opportunity for a tax saving that has been overlooked; obviously such a discovery tends to enhance the client's appreciation of the services rendered by the auditors.

The auditors should analyze the Income Taxes Payable account and vouch all amounts to income tax returns, paid checks, or other supporting documents. The final balance in the Income Taxes Payable account will ordinarily equal the computed federal, state, and foreign taxes on the current year's income tax returns, less any payments thereon.

The tax expected to be paid by a corporation often differs from the actual tax paid due to temporary differences between taxable income and pretax accounting income. These differences result in the need to establish deferred tax liabilities or assets. The auditors determine the amount of deferred tax liabilities using schedules referred to as "tax accrual" working papers, which usually are reviewed by one of the CPA firm's tax specialists.

Besides reviewing the computation of the income tax liability for the current year, the auditors should determine the date on which income tax returns for prior years were examined by IRS agents, as well as the particulars of any disputes or additional assessments. Review of the reports of revenue agents is also an essential step. In the first audit of a new client, the auditors should review any prior years' income tax returns not yet examined by revenue agents to make sure that there has been no substantial underpayment of taxes that would warrant presentation as a liability.

Accrued Professional Fees

Fees of professional firms include charges for the services of attorneys, public accountants, consulting engineers, and other specialists who often render services of a continuing

nature but present bills only at infrequent intervals. By inquiry of officers and by review of corporate minutes, the auditors may learn of professional services received for which no liability has yet been reflected in the accounts. Review of the expense account for legal fees is always essential because it may reveal damage suits, tax disputes, or other litigation warranting disclosure in the financial statements.

Balance Sheet Presentation

Accrued expenses—interest, taxes, rent, and wages—are included in the current liability section of the balance sheet and sometimes combined into one figure. Income taxes payable, however, may be sufficiently material to be listed as a separate item. Deferred federal income taxes resulting from tax allocations should be classified as current liabilities (or assets) if they relate to the next year. Otherwise, deferred federal income taxes are classified as noncurrent.

Deferred credits to revenue for such items as rent or interest collected in advance that will be included in earnings in the succeeding period are customarily included in current liabilities. Deposits on contracts and similar advances from customers also are accorded the status of current liabilities because the receipt of an advance increases the current assets total and because the goods to be used in liquidating the advance are generally included in current assets.

Time of Examination

The nature and amount of **trade accounts payable** may change greatly within a few weeks' time; consequently, the auditors' verification of these rapidly changing liabilities is most effective when performed immediately after the balance sheet date. As emphasized at the beginning of this chapter, failure to record a liability will cause an overstatement of financial position. Audit work on accounts payable performed before the balance sheet date is of little value if the client fails to record important liabilities coming into existence during the remaining weeks of the year under audit. For this reason, many auditors believe that most of the audit work on accounts payable should be performed *after the balance sheet date*. Certainly, the auditors' search for unrecorded liabilities must be made after the balance sheet date because this search is concentrated on the transactions occurring during the first few weeks of the new year.

Some current liability accounts other than accounts payable are more suitable for preliminary audit work. The documents relating to accrued property taxes, for example, may be available in advance of the balance sheet date. Amounts withheld from employees' pay also can be reviewed before the end of the year. The propriety of amounts withheld and of amounts remitted to the tax authorities during the year can be verified before the pressure of year-end work begins. The working papers relating to such liability accounts then may be completed very quickly after the end of the accounting period.

Chapter Summary

This chapter explained the fundamental controls over accounts payable and purchase transactions. It also discussed the auditors' consideration of these controls and the substantive procedures for accounts payable and purchases. To summarize:

1. Accounts payable are short-term obligations arising from the purchase of goods and services in the ordinary course of the business.
2. The purchases cycle includes initiating and authorizing purchases, ordering goods and services, and recording and paying accounts payable. Effective internal control over purchase transactions is best achieved by having separate departments responsible for purchasing, receiving, and accounting for the transactions. In this manner, payments are made only for those purchases that are properly authorized and received.
3. The auditors' principal objectives for the substantive procedures for accounts payable and purchases are to (a) substantiate the existence of recorded accounts payable and the occurrence of purchase transactions, (b) establish the completeness of accounts

payable and purchase transactions, (c) determine that the client has obligations to pay the recorded accounts payable, (d) verify the cutoff of purchase transactions, (e) determine the appropriate valuation and accuracy of accounts payable, and (f) determine that the presentation and disclosure of accounts payable and purchases are appropriate.

4. In auditing accounts payable and other liabilities, it is important for the auditors to remember that an understatement of liabilities will exaggerate the financial strength of a company in the same way as an overstatement of assets. Therefore, the auditors' substantive procedures primarily focus on the objective of determining the completeness of recorded amounts. A number of these procedures involve inspecting documents related to transactions occurring during the subsequent period to determine whether these items should have been recorded as liabilities at year-end.
5. Accrued liabilities represent obligations payable for services received before the balance sheet date that will be paid in the subsequent period. Examples include accrued warranty liabilities, accrued payroll, and accrued pension liabilities. The substantive procedures to audit these liabilities generally include inspection of documents, recomputation, and analytical procedures.

Key Terms Introduced or Emphasized in Chapter 14

Accrued liabilities (accrued expenses) (666) Short-term obligations for services of a continuing nature that accumulate over time. Examples include interest, taxes, rent, salaries, and pensions. They generally are not evidenced by invoices or statements.

Confirmation (676) Direct communication with vendors or suppliers to determine the amount of an account payable. Represents high-quality evidence because it is a document created outside the client organization and transmitted directly to the auditors.

Consignment (678) A transfer of goods from the owner to another person who acts as the sales agent of the owner.

Subsequent period (678) The time extending from the balance sheet date to the date of the auditors' report.

Trade accounts payable (685) Current liabilities arising from the purchase of goods and services from trade creditors, generally evidenced by invoices or statements received from the creditors.

Vendor's statement (669) A monthly statement prepared by a vendor (supplier) showing the beginning balance, charges during the month for goods or services, amounts collected, and ending balance. This externally created document should correspond (except for timing differences) with an account in the client's accounts payable subsidiary ledger.

Voucher (668) A document authorizing a cash disbursement. A voucher usually provides space for the initials of employees performing various approval functions. The term *voucher* may also be applied to the group of supporting documents used as a basis for recording liabilities or for making cash disbursements.

Voucher register (673) A journal used in a voucher system to record liabilities requiring cash payment in the near future. Every liability recorded in a voucher register corresponds to a voucher authorizing future payment.

Review Questions

- 14-1. If a corporation overstates its earnings, are its liabilities more likely to be overstated or understated? Explain.
- 14-2. Lawsuits against CPA firms are most likely to allege that the auditors were negligent in not detecting which of the following? (a) overstatement of liabilities and earnings, (b) understatement of assets and earnings, or (c) overstatement of owners' equity. Explain the reasoning underlying your choice.
- 14-3. Assume that a highly placed employee has stolen company assets and is now planning to conceal the fraud by failing to make an accounting entry for a large transaction. Would the omission probably be for a transaction creating an asset or a liability? Explain.
- 14-4. Suggest two reasons the adjustments proposed by independent auditors more often than not call for reducing recorded earnings.
- 14-5. Compare the auditors' approach to the verification of liabilities with their approach to the verification of assets.

- 14-6. The auditors usually find in the client's possession documentary evidence, such as invoices, supporting both accounts receivable and accounts payable. Is there any difference in the quality of such evidence for accounts receivable and for accounts payable? Explain.
- 14-7. Describe briefly an internal control activity that would prevent a paid disbursement voucher from being presented for payment a second time.
- 14-8. The operating procedures of a well-managed accounts payable department will provide for the verification of several specific points before a vendor's invoice is recorded as an approved liability. What are the points requiring verification?
- 14-9. List the major responsibilities of an accounts payable department.
- 14-10. In achieving adequate internal control over operations of the accounts payable department, a company should establish procedures that will ensure that extensions and footings are proved on all invoices and that the propriety of prices is reviewed. What is the most effective means of assuring consistent performance of these duties?
- 14-11. Which do you consider the more significant step in establishing strong internal control over accounts payable transactions: the approval of an invoice for payment or the issuance of a check in payment of an invoice? Explain.
- 14-12. For which documents relating to the accounts payable operation would you recommend the use of serial numbers as an internal control activity?
- 14-13. What internal control activity would you recommend to call attention to a failure to pay invoices within the discount period?
- 14-14. During the verification of the individual invoices composing the total of accounts payable at the balance sheet date, the auditors discovered some receiving reports indicating that the merchandise covered by several of these invoices was not received until after the balance sheet date. What action should the auditors take?
- 14-15. As part of the investigation of accounts payable, auditors sometimes vouch entries in selected creditors' accounts back through the journals to original documents, such as purchase orders, receiving reports, invoices, and paid checks. What is the principal purpose of this procedure?
- 14-16. Outline a method by which the auditors may test the propriety of cash discounts taken on accounts payable.
- 14-17. Is the confirmation of accounts payable by direct communication with vendors as useful and important an audit procedure as such confirmation of accounts receivable? Explain.
- 14-18. Whitehall Company records its liabilities in an accounts payable subsidiary ledger. The auditors have decided to select some of the accounts for confirmation by direct communication with vendors. The largest volume of purchases during the year has been made from Ranchero Company, but at the balance sheet date this account has a zero balance. Under these circumstances, should the auditors send a confirmation request to Ranchero Company, or would they accomplish more by limiting their confirmation to accounts with larger year-end balances?
- 14-19. Vendors' statements and accounts payable confirmations are both forms of documentary evidence created outside the client organization and useful in audit work on accounts payable. Which of these two represents higher-quality evidence? Why?
- 14-20. Explain how the auditors coordinate the year-end cutoff of accounts payable with their observation of the year-end physical inventory.
- 14-21. Identify three audit procedures (other than "Search for unrecorded accounts payable") that are concerned directly or indirectly with disclosing unrecorded accounts payable.
- 14-22. What do you consider to be the most important single procedure in the auditors' search for unrecorded accounts payable? Explain.
- 14-23. What is the purpose of the auditors' review of cash payments subsequent to the balance sheet date?
- 14-24. Most auditors are interested in performing as many phases of an audit as possible in advance of the balance sheet date. The verification of accounts payable, however, generally is regarded as something to be done after the balance sheet date. What specific factors can you suggest that make the verification of accounts payable less suitable than many other accounts for interim work?
- 14-25. What documentary evidence created outside the client's organization is particularly important to the auditors in verifying accrued property taxes?
- 14-26. What differences should auditors expect to find in supporting evidence for accrued liabilities as contrasted with accounts payable?

Questions Requiring Analysis

LO 14-1, 6

Select questions are available with Connect



14-27. Auditors usually send confirmations to obtain evidence about accounts receivable and accounts payable.

- Is confirmation presumptively required for accounts receivable, accounts payable, or both?
- Are accounts receivable requests, accounts payable requests, or both mailed by the auditors (as opposed to client personnel)?
- Which assertion do confirmation results most directly address—existence or completeness?

LO 14-4, 6

14-28. In the course of your initial audit of the financial statements of Sylvan Company, you determine that of the substantial amount of accounts payable outstanding at the close of the period, approximately 75 percent is owed to six creditors. You have requested that you be permitted to confirm the balances due to these six creditors by communicating with the creditors, but the president of the company is unwilling to approve your request on the grounds that correspondence in regard to the balances—all of which contain some overdue items—might give rise to demands on the part of the creditors for immediate payment of the overdue items and thereby embarrass Sylvan Company.

Given these circumstances, what alternative procedure would you adopt in an effort to satisfy yourself that the accounting records show the correct amounts payable to these creditors?

(AICPA, adapted)

LO 14-6

14-29. The subsequent period in an audit is the time extending from the balance sheet date to the date of the auditors' report. Discuss the importance of the subsequent period in the audit of trade accounts payable.

LO 14-1, 3, 4, 6

14-30. Early in your first audit of Star Corporation, you notice that sales and year-end inventory are almost unchanged from the prior year. However, cost of goods sold is less than in the preceding year, and accounts payable also are down substantially. Gross profit has increased, but this increase has not carried through to net income because of increased executive salaries. Management informs you that sales prices and purchase prices have not changed significantly during the past year, and there have been no changes in the product line. Star Corporation relies on the periodic inventory system. Your initial impression of internal control is that several weaknesses may exist.

Suggest a possible explanation for the trends described, especially the decrease in accounts payable while sales and inventory were constant and gross profit increased. Explain fully the relationships involved.

LO 14-1, 4, 6

14-31. During the course of any audit, the auditors are always alert for unrecorded accounts payable or other unrecorded liabilities. For each of the following audit areas, (a) describe an unrecorded liability that might be discovered and (b) state what auditing procedure or procedures might bring it to light.

- Construction in progress (property, plant, and equipment).
- Prepaid insurance.
- License authorizing the client to produce a product patented by another company.
- Minutes of directors' meetings.

LO 14-1, 6

14-32. Describe the audit steps that generally would be followed in establishing the propriety of the recorded liability for federal income taxes of a corporation you are auditing for the first time. Consideration should be given to the status of (a) the liability for prior years and (b) the liability arising from the current year's taxable income.

Objective Questions

LO 14-6

14-33. Multiple Choice Questions

Select the best answer for each of the following and explain the reason for your selection.

- Which of the following procedures is *least* likely to be completed before the balance sheet date?
 - Confirmation of receivables.
 - Search for unrecorded liabilities.
 - Observation of inventory.
 - Review of internal accounting control over cash disbursements.
- An audit of the balance in the accounts payable account is ordinarily not designed to:
 - Detect accounts payable that are substantially past due.
 - Verify that accounts payable were properly authorized.

LO 14-2, 4, 6

- (3) Ascertain the reasonableness of recorded liabilities.
 (4) Determine that all existing liabilities at the balance sheet date have been recorded.
- LO 14-4, 6** c. Which of the following is the best audit procedure for determining the existence of unrecorded liabilities?
- (1) Examine confirmation requests returned by creditors whose accounts appear on a subsidiary trial balance of accounts payable.
 (2) Examine unusual relationships between monthly accounts payable balances and recorded purchases.
 (3) Examine a sample of invoices a few days prior to and subsequent to year-end to ascertain whether they have been properly recorded.
 (4) Examine selected cash disbursements in the period subsequent to year-end.
- LO 14-1, 4, 6** d. Auditor confirmation of accounts payable balances at the balance sheet date may be unnecessary because:
- (1) This is a duplication of cutoff tests.
 (2) Accounts payable balances at the balance sheet date may *not* be paid before the audit is completed.
 (3) Correspondence with the audit client's attorney will reveal all legal action by vendors for nonpayment.
 (4) There is likely to be other reliable external evidence available to support the balances.
- LO 14-1, 3, 5** e. A client erroneously recorded a large purchase twice. Which of the following internal control measures would be most likely to detect this error in a timely and efficient manner?
- (1) Footing the purchases journal.
 (2) Reconciling vendors' monthly statements with subsidiary payable ledger accounts.
 (3) Tracing totals from the purchases journal to the ledger accounts.
 (4) Sending written quarterly confirmation to all vendors.
- LO 14-3, 5** f. For effective internal control, the accounts payable department should compare the information on each vendor's invoice with the:
- (1) Receiving report and the purchase order.
 (2) Receiving report and the voucher.
 (3) Vendor's packing slip and the purchase order.
 (4) Vendor's packing slip and the voucher.
- LO 14-3, 6** g. When confirming accounts payable, the approach is most likely to be one of:
- (1) Selecting the accounts with the largest balances at year-end, plus a sample of other accounts.
 (2) Selecting the accounts of companies with whom the client has previously done the most business, plus a sample of other accounts.
 (3) Selecting a random sample of accounts payable at year-end.
 (4) Confirming all accounts.
- LO 14-2, 6** h. In an audit, the valuation of year-end accounts payable is most likely addressed by:
- (1) Confirmation.
 (2) Examination of cash disbursements immediately prior to year-end.
 (3) Examination of cash disbursements immediately subsequent to year-end.
 (4) Analytical procedures applied to vouchers payable at year-end.
- LO 14-1, 2** i. Ordinarily, the most significant assertion relating to accounts payable is:
- (1) Completeness.
 (2) Existence.
 (3) Presentation.
 (4) Valuation.
- LO 14-1, 6** j. The *least* likely approach in auditing management's estimate relating to an accrued liability is to:
- (1) Independently develop an estimate of the amount to compare to management's estimate.
 (2) Review and test management's process of developing the estimate.
 (3) Review subsequent events or transactions bearing on the estimate.
 (4) Send confirmations relating to the estimate.

LO 14-3, 5

k. To determine that each voucher is submitted and paid only once, when a payment is approved, supporting documents should be canceled by the:

- (1) Authorized members of the audit committee.
- (2) Accounting department.
- (3) Individual who signs the checks.
- (4) Chief executive officer.

LO 14-2, 6

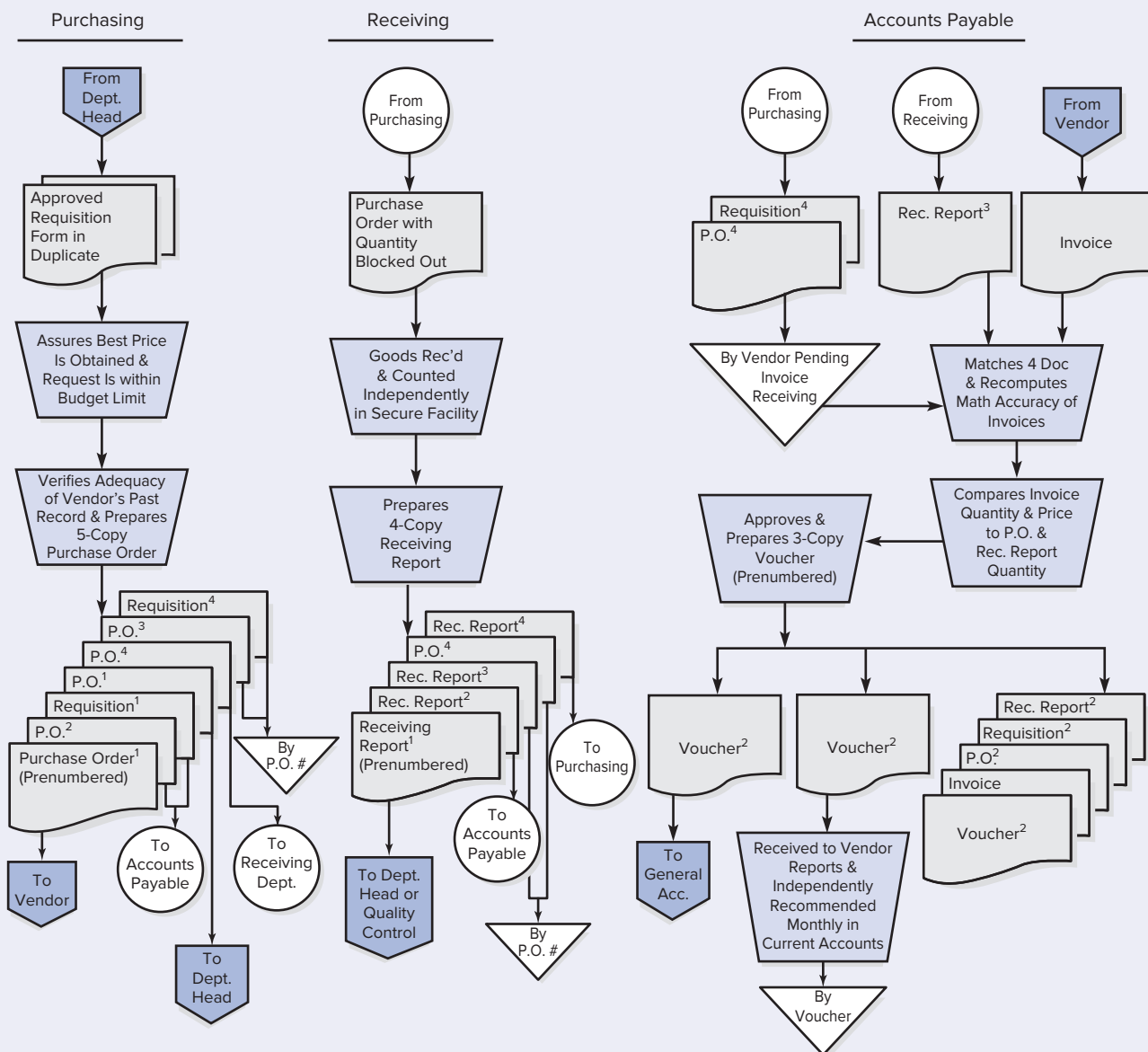
l. In performing a test of controls, the auditors vouch a sample of entries in the purchases journal to the supporting documents. Which assertion would this test of controls most likely test?

- (1) Completeness.
- (2) Existence.
- (3) Valuation.
- (4) Rights.

LO 14-1, 2, 5 13–34.

Simulation

The following flowchart depicts the activities relating to the purchasing, receiving, and accounts payable departments of Model Company Inc. Assume that you are a supervising assistant assigned to the Model Company audit.



Joe Werell, a beginning assistant, analyzed the flowchart and has supplemented the flowchart by making certain inquiries of the controller. He has concluded that the internal control over purchasing, receiving, and accounts payable is strong and has provided the following list of what he refers to as internal control strengths. Review his list and for each internal control strength indicate whether you agree or disagree that each represents a strength. For those in which you disagree, briefly explain why.

Internal Control Strengths Prepared by Joe Werell

<i>Purchasing</i>	a. The department head of the requisitioning department selects the appropriate supplier. b. Proper authorization of requisitions by department head is required before purchase orders are prepared. c. Purchasing department makes certain that a low-cost supplier is always chosen. d. Purchasing department assures that requisitions are within budget limits before purchase orders are prepared.
<i>Receiving:</i>	e. The adequacy of each vendor's past record as a supplier is verified. f. Secure facilities limit access to the goods during the receiving activity. g. Receiving department compares its count of the quantity of goods received with that listed on its copy of the purchase order. h. A receiving report is required for all purchases, including purchases of services. i. The requisitioning department head independently verifies the quantity and quality of the goods received. j. Requisitions, purchase orders, and receiving reports are matched with vendor invoices as to quantity and price.
<i>Accounts Payable</i>	k. Accounts payable department personnel recompute the mathematical accuracy of each invoice. l. The voucher register is independently reconciled to the control accounts monthly by the originators of the related vouchers. m. All supporting documentation is marked "paid" by accounts payable immediately prior to making it available to the treasurer. n. All supporting documentation is required for payment and is made available to the treasurer. o. The purchasing, receiving, and accounts payable functions are segregated.

LO 14-2, 6 14–35. Simulation

The auditors of SSC Company, a nonpublic company, are working on both audit objectives for the various accounts and documentation requirements. Parts (a) through (d) of this question relate to objectives, while part (e) addresses documentation.

The auditors have established the objectives listed below as a part of the audit. For each objective, select a substantive procedure (from the list of substantive procedures) that will help achieve that objective. Each of the procedures may be used once, more than once, or not at all.

<i>Audit Objectives</i>	a. Determine the existence of year-end recorded accounts payable and that the client has obligations to pay these liabilities. b. Establish the completeness of recorded accounts payable. c. Determine that the presentation and disclosure of accounts payable are appropriate. d. Determine that the valuation of warranty loss reserves is measured in accordance with GAAP.
<i>Substantive Procedures</i>	1. Obtain a trial balance of payables and reconcile with the accounts payable subsidiary ledger. 2. Vouch sales from throughout the year. 3. Vouch purchases recorded after year-end. 4. Vouch sales recorded shortly before year-end. 5. Vouch major warranty expenses paid during 20X8. 6. Inquire of management concerning the existence of related party transactions. 7. Test the computations made by the client to set up the accrual. 8. Test the reasonableness of general and administrative labor rates.

9. Confirm outstanding year-end balances of payables.
10. Confirm warranty expenses payable as of year-end.

Note: Part (e) is possible to work in a meaningful way only if you have the professional standards available—preferably in electronic form.

- e. The auditors believe that it will be necessary to depart from a requirement relating to accounts payable that is considered presumptively mandatory. Provide the AU-C section and paragraph(s) that address documentation requirements in this situation. You need only present the requirement, not the application and other explanatory material.

- LO 14-1, 4, 6** 14–36. In applying audit procedures and evaluating the results of those procedures, auditors may encounter specific information that may raise a question concerning the existence of noncompliance with laws and related party transactions. Indicate whether each of the following is more likely related to noncompliance with a law (NL) or a related party transaction (RP).

- (a) Purchases have been made from a vendor at a price well above the market price for the goods involved.
- (b) A purchasing agent's spouse has the same name as a major vendor of the company.
- (c) Unexplained payments have been made to government officials.
- (d) The company exchanged certain real estate property for similar real estate property.
- (e) A purchasing agent of the company has received large cash payments from a major vendor of the company.

LO 14-4, 5, 6 14–37. **Document Review Simulation**

This simulation, available online, presents an audit request list document for materials requested of management that has been prepared by an audit team staff member for the Keystone audit. Because this simulation addresses material presented in Chapters 10–13 (plus other general knowledge concerning auditing), we include it here. Note, however, that the information obtained through such an audit request list would be obtained very early in the audit.

The CPA firm Adams, Barnes & Co. is preparing for the year 20X5 audit of Keystone Computers & Networks Inc. (KCN), a calendar year-end nonissuer. An audit staff member started with the 20X4 year audit request list for KCN and updated it as he thought appropriate.

As the audit senior for this engagement, it is your responsibility to review and revise the year 20X5 request list for KCN as needed. Use the additional client information in the exhibits to consider the draft request list, correcting any errors and removing any inappropriate or unnecessary items, given the overall context and purpose of the list. Ensure that the 20X5 list is appropriate given the information provided.

The materiality for the year 20X5 audit has been set at \$300,000.

DOCUMENT

Keystone Computers & Networks Inc.
Year Ended December 31, 20X5
Audit Request List (Draft 1)

Please have the materials listed below ready for when we arrive on site. Unless a different date is specifically stated, these documents should be as of and for the year ended December 31, year 20X5.

- Final working trial balance.
- Bank reconciliations for June and December, year 20X5.
- Bank statements for December, year 20X5 and January, year 20X6.
- Trial balance of accounts receivable.
- Accounts receivable summarized by date of most recent purchase. (*Callout #1*)
- Property, plant, and equipment roll-forward of changes during the year.
- Furniture and fixtures purchase documentation.
- Sales of the Plumtree small business accounting system by month.
- Invoices supporting depreciation expense for the year. (*Callout #2*)

- Software development cost invoices and other support. (Callout #3)
- Support relevant to the amortization of the software development cost.
- Vouchers supporting increase in leasehold improvements. (Callout #4)
- Detailed analysis and reconciliation of each unpaid account payable at year-end. (Callout #5)
- Inventory detail by category (finished goods, WIP, raw materials).
- Documentation supporting change in capital stock outstanding. (Callout #6)
- Quarterly board of directors meeting minutes.
- Management's review of receivables from officers. (Callout #7)
- Prepaid expenses analysis.
- Accrued expenses analysis.
- Supporting documents for dividends paid.
- Account 7140.10 expense analysis. (Callout #8)

CALLOUT LIST#1*Choose an option below:*

- a. [Original text] Accounts receivable summarized by date of most recent purchase.
- b. [Delete text]
- c. Accounts receivable aged by date due.
- d. Accounts receivable summarized by length of business relationship with KCN.
- e. Accounts receivable matched with sales items.

CALLOUT LIST#2*Choose an option below:*

- a. [Original text] Invoices supporting depreciation expense for the year.
- b. [Delete text]
- c. Lawyer's letter response on expected life of fixed assets.
- d. Cash deposit slip for increase in cash for 20X5.
- e. Schedule of details of depreciation expense calculation for 20X5.

CALLOUT LIST#3*Choose an option below:*

- a. [Original text] Software development cost invoices and other support.
- b. [Delete text]
- c. Confirmation requests to developers involved with software development costs.
- d. Details of amortization of software development cost.
- e. Physical examples of the software developed.

CALLOUT LIST#4*Choose an option below:*

- a. [Original text] Vouchers supporting increase in leasehold improvements.
- b. [Delete text]
- c. Schedule of additions and retirements to leasehold improvements.
- d. Schedule of descriptions of estimated lives of this year's new additions.
- e. Schedule of tax depreciation for this year's new additions.

CALLOUT LIST #5*Choose an option below:*

- a. [Original text] Detailed analysis and reconciliation of each unpaid account payable at the balance sheet date.
- b. [Delete text]
- c. Trial balance of accounts payable at the balance sheet date.
- d. List of amortization of accounts payable at the balance sheet date.
- e. Current and past credit ratings of each supplier.

CALLOUT LIST #6*Choose an option below:*

- a. [Original text] Documentation supporting change in capital stock outstanding.
- b. [Delete text]
- c. Documentation of cash receipts related to new stock issuance.
- d. Addresses of new shareholders.
- e. Schedule supporting retained earnings effect relating to current stock.

CALLOUT LIST #7*Choose an option below:*

- a. [Original text] Management's review of receivables from officers.
- b. [Delete text]
- c. Cash of deposit receipt related to new receivables from officers.
- d. Copy of Board of Director approval of new loans from officers.
- e. Copy of loan agreement with Mr. Best.

CALLOUT LIST#8*Choose an option below:*

- a. [Original text] Account 7140.10 expense analysis.
- b. Account 1000.30 detailed analysis.
- c. Account 5100.10 detailed analysis.
- d. Account 7100.10 expense analysis.
- e. Account 7200.10 expense analysis.

EXHIBITS:

- 1. Excel Spreadsheet—KCN Working Trial Balance
- 2. Memo to Files
- 3. Forwarded E-mail from Controller to Partner
- 4. E-mail from Audit Manager to Audit Partner

EXHIBIT 1 KCN Working Trial Balance

		12/31/X4		12/31/X5 (unaud.)	
		Debit	Credit	Debit	Credit
1000.10	Cash—General account	42,754		66,034	
1000.20	Cash—Special account	9,960		10,150	
1000.30	Cash in register	1,200		1,200	
1000.40	Petty cash	50		50	
1050.10	Accounts receivable—trade	8,534,524		10,235,457	
1050.40	Accounts receivable—officers	57,643		84,670	
1040.90	Allowance for bad debts		96,000		104,000
1100.10	Inventories	1,234,589		1,375,835	
1300.10	Prepaid expenses	156,900		176,456	
2050.10	Furniture & fixtures	300,980		344,900	
2050.30	Office equipment	789,654		974,676	
2050.80	Leasehold improvements	98,900		98,900	
2050.85	Amortization of leasehold improvements				7,670
2050.90	Accumulated depreciation		250,987		404,560

		12/31/X4		12/31/X5 (unaud.)	
		Debit	Credit	Debit	Credit
2100.00	Software development cost			178,000	
2200.00	Intangible assets	1,000,000		800,000	
3050.10	Accounts payable—trade		1,349,839		1,429,033
3100.00	Capital lease obligations—current		43,200		45,675
3210.10	Accrued liabilities		178,900		203,450
3300.30	Unearned service revenue				42,300
3400.50	Line of credit		6,612,550		8,632,105
4400.10	Capital lease obligations—noncurrent		456,700		423,680
5050.10	Capital stock		200,000		200,000
5100.10	Paid-in capital		423,500		423,500
5700.10	Retained earnings		1,626,203		2,615,478
5900.00	Dividends			415,000	
6000.10	Sales of computers		44,890,788		42,345,675
6010.10	Software licenses		248,900		236,700
6020.10	Service revenue		4,567,888		4,325,777
6030.10	Consulting revenue		46,751,990		45,677,899
7020.10	Cost of sales	74,122,435		72,134,566	
7070.10	Salaries—sales	3,167,889		2,765,677	
7070.50	Payroll benefits—sales	913,456		857,368	
7075.10	Advertising & promotion	1,200,786		1,567,889	
7080.10	Travel & entertainment	609,788		445,600	
7080.30	Miscellaneous expense—sales	334,890		278,656	
7090.10	Salaries—operations	4,878,900		4,544,860	
7090.30	Salaries—administrative	4,234,234		3,945,670	
7090.50	Payroll benefits—admin.	1,812,344		1,734,565	
7100.10	Rent	797,800		721,345	
7140.10	Utilities	210,495		234,839	
7200.10	Insurance	356,890		378,677	
7260.30	Legal & accounting	457,577		485,767	
7320.10	Bad debt expense	234,500		256,678	
7410.10	Supplies	556,345		478,900	
7600.10	Depreciation and amort.	334,565		367,867	
7650.10	Software development cost	289,100		345,645	
7700.10	Miscellaneous exp.—administrative	234,556		245,456	
7800.10	Interest expense	421,344		476,899	
7900.10	Current income taxes	256,765		80,100	
7900.70	Deferred income taxes	45,632		9,150	
		107,697,445	107,697,445	107,117,502	107,117,502

EXHIBIT 2

Memo to Files: Upcoming Keystone Computers & Networks Inc. (KCN) Audit
Charles Adams, Partner
November 5, 20X5

Mr. Loren Steele, controller of Keystone computers, joined me for lunch today. While this was an informal get together, we did speak some about the coming audit.

- He suggested that he would appreciate it if we could get together our audit request list of the various documents and other materials that we would like them to prepare for the audit as soon as possible.
- Keystone has hired a number of outstanding young employees with particularly strong IT skills.
- The year-end 20X3 purchase of Plumbtree Systems, a small business accounting system, is not working out as well as they had hoped as sales are slow. Recently the software was rated poorly by a trade association journal and it has been suggested that it is somewhat dated. Mr. Steele indicated that while the intangible asset account related to it was amortized \$200,000 in 20X4 (based on a six-year amortization period), the firm would have to “come to grips” with whether to write off more than \$200,000 this year. His thought was that it might well be necessary to write off half or more of the remaining \$1,000,000 this year. He stated that on top of that, KCN total earnings so far this year were down about 40 percent as compared to the end of the third quarter last year.
- He indicated to me that he would forward details related to the software development costs the company started capitalizing this year. After lunch he forwarded an e-mail from Mr. Sam Best, President, to him on this. See Exhibit 3.
- There will be an increase in the accounts receivable from officers as President Best asked for and obtained a loan from the company—this is a loan agreement Mr. Steele signed with the company, not a simple receivable. Because its amount was slightly below the amount necessary for Board of Directors approval, the matter was not addressed by the Board.
- Finally, on a more personal level, he told me that his wife had recently inherited a large sum of cash and they were in the enviable position of investing it. They recently bought a large, distinguished, old house in Jerome, AZ, that they will use as a “vacation” home. He invited my wife and me to come visit them some weekend.

EXHIBIT 3**Forwarded E-mail from Controller to Partner**

TO: Sam Best, Partner
FROM: Loren Steele, Controller, KCN
SUBJECT: RE: Software Development
DATE: November 5, 20X5

FYI

Loren

E-mail

TO: Loren Steele, Controller
FROM: Sam Best, President
SUBJECT: Software Development
DATE: August 12, 20X5

As you know, we have spent significant amounts on software development. Although we are at an early stage here, let's make sure that we capitalize these costs (\$178,000) because, ultimately, we may be able to develop software that not only do we use, but so do our customers. These expenditures could lead to greatly enhanced sales after a year or two.

Sam

PS: Did I tell you that, even though the rent on our building is going up, the new lease doesn't require a payment for the first three months? At least that's good.

EXHIBIT 4**E-mail from Audit Manager to Audit Partner**

TO: Charles Adams, KCN, Partner
 FROM: Karen West, Manager
 SUBJECT: KCN Allowance for Doubtful Accounts
 DATE: December 29, 20X5

I spoke with Wilbur Wood, manager of collections.

Although KCN does not yet have its final working trial balance, it seems at this point that the allowance for bad debts will go from \$96,000 in 20X4 to \$104,000 in 20X5.

During the year, the Willay Co. receivable for \$208,234 was written off completely due to Willay's bankruptcy and the fact that the expected amount recoverable on the account is zero.

In addition, he said that he had pointed out and discussed with the controller three accounts totaling a bit less than \$32,000 that may not be collectible.

Given the level of accounts receivable, we definitely need to consider the adequacy of the allowance for bad debts.

Problems**LO 14-1, 3, 5**

14–38. The following are typical questions that might appear on an internal control questionnaire for accounts payable.

1. Are monthly statements from vendors reconciled with the accounts payable listing?
2. Are vendors' invoices matched with receiving reports before they are approved for payment?
 - a. Describe the purpose of each of the above internal control activities.
 - b. Describe the manner in which each of the above procedures might be tested.
 - c. Assuming that the operating effectiveness of each of the above procedures is found to be inadequate, describe how the auditors might alter their substantive procedures to compensate for the increased level of the risk of material misstatement.

LO 14-1, 3, 6

14–39. As part of your first audit of the financial statements of Marina del Rey Inc., you have decided to confirm some of the accounts payable. You are now in the process of selecting the individual companies to whom you will send accounts payable confirmation requests. Among the accounts payable you are considering are the following:

Company	Amount Payable at Year-End	Total Purchases from Vendor during Year
Dayco Inc.	\$ —	\$1,980,000
Gearbox Inc.	22,650	46,100
Landon Co.	65,000	75,000
Western Supply	190,000	2,123,000

- a. Which two of the above four accounts payable would you select as the most important to confirm? Explain your choice in terms of the audit objectives in sending accounts payable confirmation requests.
- b. Assume that you are selecting accounts receivable to be confirmed. Assume also that the four companies listed above are customers of your client rather than suppliers and that the dollar amounts are accounts receivable balances and total sales for the year. Which two companies would you select as the most important to confirm? Explain your choice.

LO 14-1, 3, 6

14–40. Clark, CPA, is engaged in the audit of Tower Wholesaling for the year ended December 31. Clark obtained an understanding of internal control relating to the purchasing, receiving, trade accounts payable, and cash disbursement cycles and has decided not to proceed with tests of

controls. Based upon analytical procedures, Clark believes that the trade accounts payable on the balance sheet as of December 31 may be understated.

Clark requested and obtained a client-prepared trade accounts payable schedule listing the total amount owed to each vendor.

What additional substantive audit procedures should Clark apply in examining the trade accounts payable?

- LO 14-1, 3, 6** 14-41. Nancy Howe, your staff assistant on the April 30, 20X2, audit of Wilcox Company, was transferred to another audit engagement before she could complete the audit of unrecorded accounts payable. Her working paper, which you have reviewed and are satisfied is complete, appears below.

		Wilcox Company			
		Unrecorded Accounts Payable		M-1-1	
		April 30, 20X2			
Invoice					
Date	Vendor and Description			Amount	
	Hill & Harper—unpaid legal fees at Apr. 30, X2 (See lawyer's letter at M-4)			1000	y
Apr.1,X2	Drew Insurance Agency—unpaid premium at year-end on fire insurance for period Apr. 1, X2- Mar. 31, X3 (See insurance broker letter at J-1-1). Payment made on May 7, 20X2.			1800	y
Apr.30,X2	Mays and Sage, Stockbrokers—advice for 100 shares of Madison Ltd. common stock (settlement date May 7, X2)			2125	— y
	Lane Company—shipment received Apr. 30, X2 per receiver no. 3361 and included in Apr. 30, X2, physical inventory; invoice not yet received (amount is per purchase order)			5863	— y
				10788	—
	y-Examined document described.				
	In my opinion, the \$10,788 adjustment includes all material unrecorded accounts payable.				
				N.A.H.	
				May 29, X2	

Prepare a proposed adjusting journal entry for the unrecorded accounts payable of Wilcox Company at April 30, 20X2. The amounts are material. (Do not deal with income taxes.)

- LO 14-1, 3, 4, 6** 14-42. Your client, Software and Stuff (Software), has developed a new electronic game. One part of the game uses software developed by another company, Component of Yuma (Component). Software signed an agreement with Component that provides that Software will pay Component a royalty of \$1.00 per game sold. At year-end you note that a material liability is payable by Software to Component under the terms of the royalty agreement. Provide a list of procedures that should be performed on the royalty liability and the related royalty expense for the year.

In-Class Team Case

LO 14-1, 3, 4, 6



- 14-43. You have just been assigned as a member of the audit team of Bozarkana Company (a new client) and are considering accounts payable. Bozarkana Company uses a computerized voucher system for payables. As a starting point, you asked Bill Bozarkana, the controller, for a summary of payables and received the following schedule of more than 1,000 unpaid vouchers at year-end:

Voucher#	Vendor Number	Purchase Order#	Receiving Report#	Date Payment Due	Amount
2334555	2133	654444	106500	1/2/0Y	\$ 2,020.21
2334558	1098	654579	106820	1/2/0Y	12,344.56
2334567	2133	654593	106920	1/2/0Y	322.43
⋮					
⋮					
⋮					
2335643	2231	655456	107654	1/28/0Y	2,346.62
TOTAL PAYABLE					\$2,225,980.83

File Name	Information in Table	Comment
Purchase requisitions	Purchase requisition number Date requisitioned Item number Item description Quantity	The table includes one row for each purchase requisition—only one type of item per requisition may be requisitioned.
Purchase orders	Purchase order number Date ordered Purchase requisition number Vendor number Item number Quantity Cost	The table includes multiple rows for each purchase order—one for each item ordered.
Receiving reports	Receiving report number Date shipped Date received Item number Quantity	The table includes multiple rows for each receiving report—one for each item received.
Vendor master	Vendor number Vendor name Vendor address	The table includes one line for each vendor.
Cash disbursements	Disbursement number Vendor number Check number or electronic funds transfer number Voucher number Amount	The table includes one line for each check or funds transfer (electronic payment).

Bill Bozarkana has indicated that the schedule is a listing of the vouchers payable file as of year-end and that the total is the result of a separate question (query) of that file asking for total payables. You have the schedule in electronic and hard-copy form. Vouchers are issued sequentially, and voucher number 2335643 was the last one issued prior to year-end. You also have obtained the information relating to the following other computer files, which are available to you in electronic form, as shown above.

The client has made copies of these files available so that you and the assistant can perform the necessary steps on the files. Furthermore, you have compared these copies to the client's

copies and find that they are identical. Finally, you may assume that tests of controls have been performed on the controls related to the dates on the files. The controls were found to be effective.

- a. Discuss how you would establish samples in the following situations:
 - (1) Randomly select 30 vouchers as of year-end and obtain the necessary information to send confirmations.
 - (2) Randomly select 30 accounts with balances payable (per vendor) as of December 31.
 - (3) Select all accounts (per vendor) with which the company has disbursed more than \$500,000 during the year, but whose balance at year-end is zero.
- b. Provide detailed guidance on the following:
 - (1) All purchases are sent to Bozarkana Company “FOB shipping point.” Identify a procedure for testing whether any items shipped to the client prior to year-end have been omitted from vouchers payable as of year-end.
 - (2) Select all disbursements over \$300,000 in the first two weeks of January, and, for those not included as liabilities as of December 31, determine whether title to the goods had passed as of year-end, resulting in an unrecorded liability.

Appendix 14A

Illustrative Audit Case: Keystone Computers & Networks Inc.

Part IV: Consideration of Internal Control

This part of the audit case of Keystone Computers & Networks Inc. (KCN) illustrates the nature of internal control over the acquisition cycle and the way in which auditors assess control risk for this cycle. The following working papers are included:

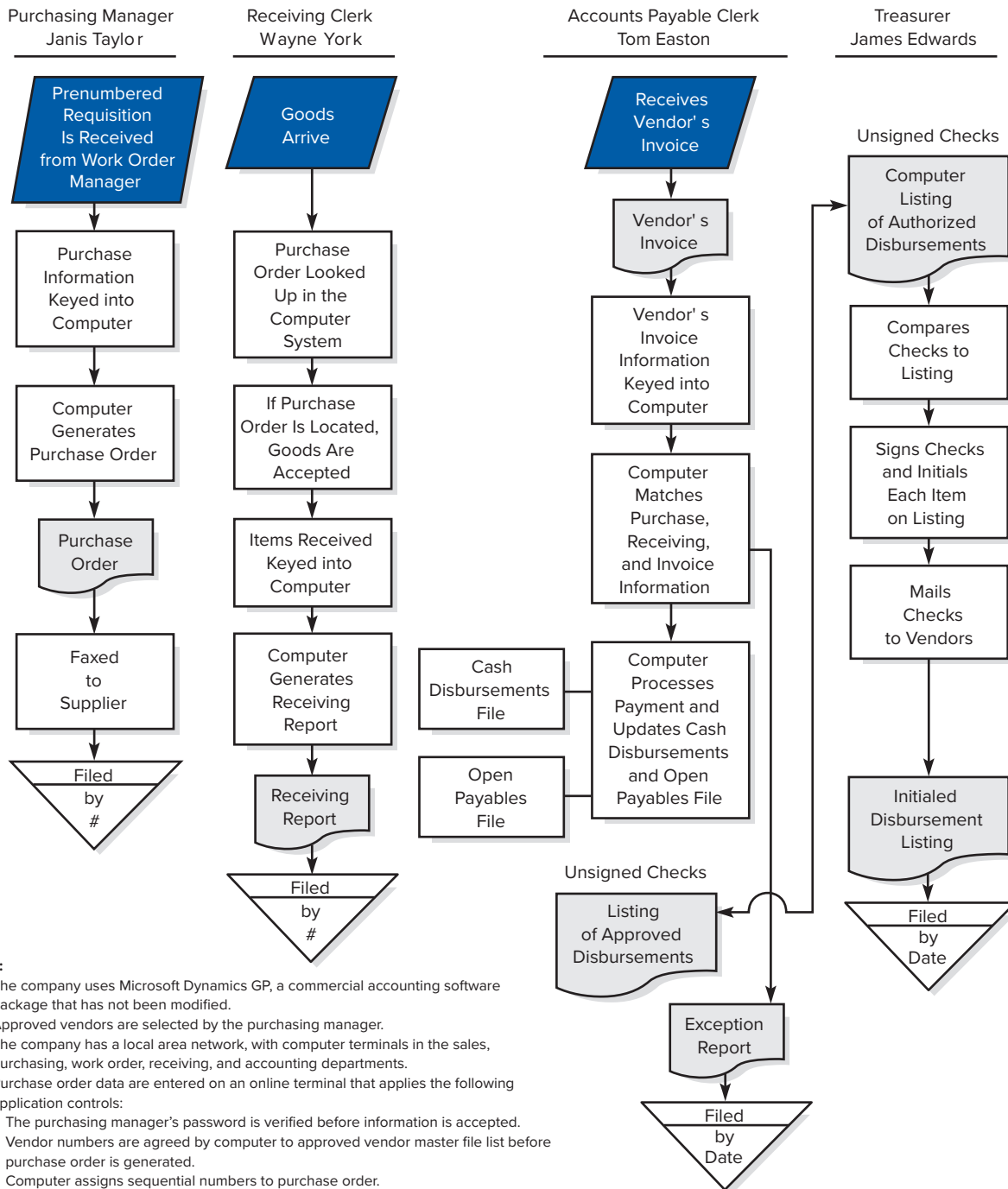
- A flowchart description of the acquisition cycle of the company and the related controls prepared by the staff of Adams, Barnes & Co. (ABC), CPAs. This flowchart focuses on the (accounting) information system and control activities.
- ABC’s working paper for the assessment of control risk for accounts payable and purchases as it would appear before any tests of controls are performed. This working paper identifies the prescribed controls and weaknesses for the revenue cycle. It also relates the controls and weaknesses to the various financial statement assertions about accounts payable and purchases.

You should read through the information to obtain an understanding of typical controls for this cycle. You also may wish to review the planning documentation presented in Appendix 6C to refresh your knowledge about the nature of the company’s business and its environment. The Control Environment, Risk Assessment, Monitoring Questionnaire, and Organizational Chart of KCN in Appendix 11A can be used to help refresh your memory about these components of internal control.

KEYSTONE COMPUTERS & NETWORKS INC.
Assessment of Control Risk—Acquisition Cycle
12/31/X5

Internal Controls	Existence or Occurrence	Completeness	Cutoff	Rights and Obligations	Valuation and Accuracy	Presentation and Disclosure
Sales						
1. Separation of duties for authorization of purchases, receiving merchandise, approving payment to vendors, and signing checks.	☐	☐		☐	☐	
2. Computer assigns number to purchase orders, receiving reports, and checks.		☐	☐			
3. Computer matches information from vendors' invoices with purchase orders and receiving data.	☐		☐	☐		
4. Computer tests numerical accuracy of vendors' invoices.					☐	
5. Approval of vendors' invoices prior to payment.	☐			☐	☐	
6. Checks are mailed by the check signer.		☐			☐	
7. Monthly reconciliation of bank accounts by an employee who is independent of invoice processing, cash disbursements, cash receipts, petty cash, and general ledger functions.	☐	☐		☐	☐	
8. Comparison of actual disbursements to budgeted amounts and investigation of variances.	☐	☐			☐	☐
Internal Control Weakness						
1. Approved vendors are selected by purchasing manager who also purchases goods.					X	
2. Vendors' statements are not reconciled to the accounting records.	X	X			X	
Planned Assessed Level of Control Risk	<i>Low</i>	<i>Moderate</i>	<i>Moderate</i>	<i>Low</i>	<i>Moderate</i>	<i>Maximum</i>

KEYSTONE COMPUTERS & NETWORKS INC.
Internal Control—Acquisition Cycle
12/31/X5

**Notes:**

- The company uses Microsoft Dynamics GP, a commercial accounting software package that has not been modified.
- Approved vendors are selected by the purchasing manager.
- The company has a local area network, with computer terminals in the sales, purchasing, work order, receiving, and accounting departments.
- Purchase order data are entered on an online terminal that applies the following application controls:
 - The purchasing manager's password is verified before information is accepted.
 - Vendor numbers are agreed by computer to approved vendor master file list before purchase order is generated.
 - Computer assigns sequential numbers to purchase order.
- Receiving information is entered on an online terminal that applies the following controls:
 - The receiving clerk's password is verified before information is accepted.
 - Computer assigns sequential numbers to purchase order.
- Vendors' invoice information is entered on an online terminal that applies the following controls:
 - The accounts payable clerk's password is verified before information is accepted.
 - The computer recomputes the individual items and the total amount of the invoice.
- Computer agrees with purchase order, receiving, and invoice data and produces an exception report for any situation in which the documents do not match. Accounts payable clerk follows up on exceptions and describes resolution on report.
- Computer updates cash disbursements and open payables files.
- The accounting manager reconciles the cash and open payables accounts to the general ledger on a monthly basis.
- The accounting manager reconciles the bank account on a monthly basis.
- Cash disbursements are budgeted and the controller analyzes and explains variances.

Appendix 14A Problems

Required:

LO 14-1, 3, 5, 6

14A-1. A summary of the controls for the acquisition cycle of Keystone Computers & Networks, Inc., appears in Appendix 14A.

a. For the following three controls over the acquisition cycle, indicate one type of error or fraud that the control serves to prevent or detect. Organize your solution as follows:

Control	Error or Fraud Controlled
1. Computer matches information from vendors' invoice with purchase order and receiving data.	
2. The computer assigns numbers to receiving reports.	
3. Checks are mailed by check signer.	

b. For each of the controls described above, indicate how the auditors could test the control. Organize your answer as follows:

Control	Tests of Controls
1. Computer matches information from vendors' invoice with purchase order and receiving data.	
2. The computer assigns numbers to receiving reports.	
3. Checks are mailed by check signer.	

LO 14-1, 4, 5 14A-2. As indicated on the control risk assessment working paper in Appendix 14A, the auditors identified two weaknesses in internal control over the acquisition cycle of KCN. Describe the implications of each of the two weaknesses in terms of the type of errors or fraud that could result.

LO 14-3, 5, 6 14A-3. The auditors' working paper that relates control strengths and weaknesses to the assertions about purchases and accounts payable is presented in Appendix 14A. This working paper also presents the auditors' planned assessed level of control risk for each of the assertions.
Prepare an audit plan for tests of the controls over the acquisition cycle. (Note: You may want to use the tests of controls plan for the revenue cycle, which is in Appendix 11A, as a guide.)

Debt and Equity Capital

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 15-1** Describe the nature of debt.
- LO 15-2** Describe the auditors' objectives in auditing debt.
- LO 15-3** Use the understanding of the client and its environment to consider inherent risks (including fraud risks) related to debt.
- LO 15-4** Obtain an understanding of internal control over the financing cycle.
- LO 15-5** Assess the risks of material misstatement of debt and design further audit procedures to address the risks.
- LO 15-6** Describe the nature of equity accounts.
- LO 15-7** Describe the auditors' objectives in the audit of equity accounts.
- LO 15-8** Obtain an understanding of the fundamental controls over capital stock and other types of equity accounts.
- LO 15-9** Describe further audit procedures for equity accounts.

Business corporations obtain substantial amounts of their financial resources by incurring debt and issuing capital stock. The acquisition and repayment of capital is sometimes referred to as the *financing cycle*. This transaction cycle includes the sequence of procedures for authorizing, executing, and recording transactions that involve bank loans, mortgages, bonds payable, and capital stock as well as the payment of interest and dividends. In this chapter, we present material on the auditors' approach to both debt and equity capital accounts.

Debt

Source and Nature of Debt

Long-term debt usually is substantial in amount and often extends for periods of 20 years or more. Debentures, secured bonds, and notes payable (sometimes secured by mortgages or trust deeds) are the principal types of long-term debt. **Debenture bonds** are backed only by the general credit of the issuing corporation and not by liens on specific assets. Because in most respects debentures have the characteristics of other corporate bonds, we shall use the term *bonds* to include both debentures and secured bonds payable.

LO 15-1

Describe the nature of debt.

The formal document creating bond indebtedness is called the *indenture* or **trust indenture**. When creditors supply capital on a long-term basis, they often insist upon placing certain restrictions on the borrowing company. For example, the indenture often includes a restrictive covenant that prohibits the company from declaring dividends unless the amount of working capital is maintained above a specified amount. The acquisition of plant and equipment, or the increasing of managerial salaries, may be permitted only if the current ratio is maintained at a specified level and if net income reaches a designated amount. Another device for protecting the long-term creditor is the requirement of a sinking fund or redemption fund to be held by a trustee. If these restrictions are violated, the indenture may provide that the entire debt is due on demand.

The Auditors' Objectives in Auditing Debt

The auditors' *objectives* in the audit of debt are to

1. Use the understanding of the client and its environment to consider *inherent risks*, including fraud risks, related to debt.
2. Obtain an understanding of *internal control* over debt.
3. Assess the risks of material misstatement and design tests of controls and substantive procedures that
 - a. Substantiate the *existence* of debt and the *occurrence* of the related transactions.
 - b. Establish the *completeness* of recorded debt.
 - c. Verify the *cutoff* of transactions affecting debt.

LO 15-2

Describe the auditors' objectives in auditing debt.

- d. Determine that the client has *obligations* to pay the recorded debt.
- e. Establish the proper *valuation* of debt and the *accuracy* of transactions affecting debt.
- f. Determine that the *presentation* and *disclosure* of information about debt are appropriate, including disclosure of major provisions of loan agreements.

In conjunction with the audit of debt, the auditors will also obtain evidence about interest expense, interest payable, and bond discount and premium.

Many of the principles related to accounts payable also apply to the audit of other forms of debt. As is the case for accounts payable, the understatement of debt is considered to be a major potential audit problem. Related to disclosure of debt, the auditors should determine whether the company has met all requirements and restrictions imposed upon it by debt agreements.

Assessment of the Inherent Risks Related to Debt

LO 15-3

Use the understanding of the client and its environment to consider inherent risks (including fraud risks) related to debt.

A major business risk related to debt is ensuring that the client obtains capital in an effective and efficient manner. This risk is not indicative of a risk of material misstatement of the financial statements and, therefore, is not of primary concern to the auditors. However, other business risks do equate to risks of material misstatement. As an example, management must be concerned with the business risk of noncompliance with debt covenants. This is also a concern of the auditors because noncompliance may affect the classification of debt and related disclosures. Many of the principles related to accounts payable also apply to the audit of debt. As is the case for accounts payable, the understatement of debt, whether due to error or fraud, is considered to be a major potential inherent risk.



Internal Control over Debt

LO 15-4

Obtain an understanding of internal control over the financing cycle.

Authorization by the Board of Directors

Effective internal control over debt begins with the authorization to incur the debt. The bylaws of a corporation usually require that the board of directors approve borrowing. The treasurer of the corporation will prepare a report on any proposed financing, explaining the need for funds, the estimated effect of borrowing upon future earnings, the estimated financial position of the company in comparison with others in the industry both before and after the borrowing, and alternative methods of raising the funds. Authorization by the board of directors will include review and approval of such matters as the choice of a bank or trustee, the type of security, registration with the SEC, agreements with investment bankers, compliance with requirements of the state of incorporation, and listing of bonds on a securities exchange. After the issuance of long-term debt, the board of directors should receive a report stating the net amount received and its disposition, for example, as acquisition of plant assets, as addition to working capital, or for other purposes.

Use of an Independent Trustee

Bond issues are always for large amounts—usually many millions of dollars. Therefore, only relatively large companies issue bonds; small companies obtain long-term capital through mortgage loans or other sources. Any company large enough to issue bonds and able to find a ready market for the securities will almost always utilize the services of a large bank as an independent trustee.

The trustee is charged with the protection of the creditors' interests and with monitoring the issuing company's compliance with the provisions of the indenture. The trustee also maintains detailed records of the names and addresses of the registered owners of the bonds, cancels old bond certificates and issues new ones when bonds change ownership, follows procedures to prevent overissuance of bond certificates, distributes interest payments, and distributes principal payments when the bonds mature. Use of an independent trustee largely solves the problem of internal control over bonds payable. Internal control is strengthened by the fact that the trustee does not have access to the issuing company's assets or accounting records and the fact that the trustee is a large financial institution with legal responsibility for its actions.

Interest Payments on Bonds and Notes Payable

Many corporations assign the entire task of paying interest to the trustee for either *bearer bonds* or *registered bonds*. Highly effective control is then achieved because the company will issue a single check for the full amount of the semiannual interest payment on the entire bond issue. In the case of bearer bonds (coupon bonds), the trustee upon receipt of this check will make payment for coupons presented, cancel the coupons, and file them numerically. A second count of the coupons is made at a later date; the coupons then are destroyed and a cremation certificate is delivered to the issuing company. The trustee does not attempt to maintain a list of the holders of coupon bonds because these securities are transferable by the mere act of delivery. If certain coupons are not presented for payment, the trustee will hold the funds corresponding to such coupons for the length of time prescribed by statute. In the case of registered bonds, the trustee will maintain a current list of holders and will remit interest checks to them in the same manner as dividend checks are distributed to stockholders.

For a note payable, there generally is only one recipient of interest. Companies control that disbursement in the same manner as other cash disbursements, without using a trustee.

Audit Documentation

A copy of the loan agreement or the indenture relating to a bond issue should be placed in the auditors' permanent file. A listing of the restrictions placed on the company is extracted from these documents to facilitate the auditors' tests of compliance with the debt provisions. Analyses of ledger accounts for notes and bonds payable, and the related accounts for interest and discount or premium, should be obtained for the current working papers file or the permanent file. In addition, the auditors should include documentation of internal control and risk assessment for debt. A lead schedule is often not required for short-term notes payable or for long-term debt.

Audit of Debt

LO 15-5

Assess the risks of material misstatement of debt and design further audit procedures to address the risks.

After considering the information about the client and its environment, including internal control over debt, the auditors identify and assess the risks of material misstatement, identify relevant assertions, and design appropriate further audit procedures. This audit plan does not provide for the usual distinction between tests of controls and substantive procedures. This is because individual transactions will generally be examined for all large debt agreements. To document internal control, the auditors will usually prepare a written description, as well as an internal control questionnaire. Questions included on a typical questionnaire are the following: (1) Are amounts of new debt authorized by appropriate management? (2) Is an independent trustee used for all bond issues? (3) Does a company official monitor compliance with debt provisions?

Because transactions are few in number but large in dollar amount, the auditors are generally able to substantiate the individual transactions. Therefore, testing of controls occurs through what actually amounts to dual-purpose transaction testing. As discussed further in Chapter 18, in an integrated audit, more controls will be tested.

Audit procedures appropriate for the verification of debt include the following:

1. Obtain or prepare analyses of debt accounts and related interest, premium, and discount accounts.
2. Examine copies of notes payable and supporting documents.
3. Confirm debt with payees or appropriate third parties.
4. Vouch borrowing and repayment transactions to supporting documents.
5. Perform analytical procedures or data analytics to test the reasonableness of interest-bearing debt and interest expense.
6. Test the valuation of debt, computation of interest expense, interest payable, and amortization of discount or premium.
7. Evaluate whether debt provisions have been met.

FIGURE 15.1
Objectives of Major
Substantive Procedures
for Debt Transactions
and Balances

Substantive Procedures	Primary Audit Objectives
Obtain analyses of debt and related accounts.	<i>Valuation</i>
Examine copies of notes payable and supporting documents. Confirm debt. Vouch borrowing and repayment transactions.	<i>Completeness</i> <i>Existence and obligations</i> <i>Accuracy</i> <i>Cutoff</i>
Perform analytical procedures or data analytics. Test computations of interest expense, interest payable, and amortization of discount and premium.	<i>Completeness</i> <i>Existence and obligations</i> <i>Valuation</i>
Evaluate whether debt provisions have been met. Trace authority for issuance of debt to corporate minutes. Review notes payable paid or renewed after the balance sheet date. Perform procedures to identify notes payable to related parties. Send confirmation letters about financing arrangements. Evaluate financial statement presentation and disclosure.	<i>Presentation and disclosure</i>

8. Trace authority for issuance of debt to the corporate minutes.
9. Review notes payable paid or renewed after the balance sheet date.
10. Perform procedures to identify notes payable to related parties.
11. Send confirmation letters to financial institutions to obtain information about financing arrangements.
12. Evaluate proper financial statement presentation and disclosure of debt and related transactions.

Figure 15.1 relates these substantive procedures to their primary audit objectives.

Primary Audit Objective:
Valuation ☒

1. Obtain or Prepare Analyses of Debt Accounts and Related Interest, Premium, and Discount Accounts.

A notes payable analysis shows the beginning balance of each individual note, additional notes issued and payments on notes during the year, and the ending balance of each note. In addition, the beginning balances of interest payable or prepaid interest, interest expense, and interest paid and the ending balances of interest payable or prepaid interest may be presented in the analysis working paper.

An analysis of the Notes Payable account will serve a number of purposes: (a) The payment or other disposition of notes listed as outstanding in the previous year's audit can be verified, (b) the propriety of individual debits and credits can be established, and (c) the amount of the year-end balance of the account is proved through the step-by-step examination of all changes in the account during the year.

In the first audit of a client, the auditors will analyze the ledger accounts for Bonds Payable, Bond Issue Costs, and Bond Discount (or Bond Premium) for the years since the bonds were issued. The working paper is placed in the auditors' permanent file; in later audits, any further entries in these accounts may be added to the analysis.

The accounts of the financing cycle are often relatively free of material misstatement. When misstatements occur, they may be due to improper reporting of debt (e.g., a loan is recorded with a debit to cash and a credit to a revenue account), incomplete recording of debt (e.g., a loan is not recorded and the proceeds are maintained "off the books"), or improper amortization of loan-related discount and premium accounts. In some situations, note disclosures related to debt are incomplete.

The auditors also should understand the risks involved when clients have complex organizational structures involving numerous or unusual legal entities or contractual arrangements and transactions involving related parties. In these cases, questions arise as to proper recording of the transactions. Also, the auditors should realize that a lack

of compliance with the provisions of a debt agreement usually makes the debt involved entirely due and payable on demand.

2. Examine Copies of Notes Payable and Supporting Documents.

The auditors should examine the client's copies of notes payable and supporting documents such as mortgages and trust deeds. The original documents will be in the possession of the payees, but the auditors should make certain that the client has retained copies of the debt instruments and that their details correspond to the analyses described in the first procedure of this audit plan.

3. Confirm Debt with Payees or Appropriate Third Parties.

Notes payable to financial institutions are confirmed as part of the confirmation of cash deposit balances. The standard confirmation form illustrated in Chapter 10 includes a request that the financial institution confirm all borrowings by the depositor.

Confirmation requests for notes payable to payees other than financial institutions should be drafted on the client's letterhead stationery, signed by the controller or other appropriate executive, and mailed by the auditors. Payees should be requested to confirm dates of origin, due dates, unpaid balances of notes, interest rates, dates to which interest has been paid, and collateral for the notes.

The auditors may also substantiate the existence and amount of a mortgage liability outstanding by direct confirmation with the mortgagee. The information received should be compared with the client's records and the audit working papers. When no change in the liability account has occurred in the period under audit, the only major procedure necessary will be this confirmation with the creditor. At the same time that the mortgagee is asked to confirm the debt, it may be asked for an indication of the company's compliance with the mortgage or trust deed agreement.

Bond transactions usually can be confirmed directly with the trustee. The trustee's reply should include an exact description of the bonds, including maturity dates and interest rates; bonds retired, purchased for the treasury, or converted into stock during the year; bonds outstanding at the balance sheet date; and **sinking fund** transactions and balances.

4. Vouch Borrowing and Repayment Transactions to Supporting Documents.

The auditors should obtain evidence that transactions in debt accounts were valid. To accomplish this objective, the auditors vouch the cash recorded as received from the issuance of notes, bonds, or mortgages to the validated copy of the bank deposit slip and to the bank statement. Any remittance advices supporting these cash receipts are also examined. The auditors can find further support for the net proceeds of a public issue by referring to the underwriting contract and to the prospectus filed with the SEC.

Debits to a Notes Payable or a Mortgages Payable account generally represent payments in full or in installments. The auditors should examine these payments; in so doing, they also will account for payments of accrued interest. The propriety of installment payments should be verified by reference to the repayment schedule set forth in the note or mortgage copy in the client's possession.

A comparison of canceled notes payable with the debit entries in the Notes Payable account provides further assurance that notes indicated as paid during the year have, in fact, been retired. The auditors' inspection of these notes should include a comparison of the maturity date of the note with the date of cash disbursement. Failure to pay notes promptly at maturity is suggestive of financial weakness.

There is seldom any justification for a paid note to be missing from the files; a receipt for payment from the payee of the note is not a satisfactory substitute. If, for any reason, a paid note is not available for inspection, the auditors should review the request for a check or other vouchers supporting the disbursement and should discuss the transaction with an appropriate official.

In examining the canceled notes, the auditors should also trace the disposition of any collateral used to secure these notes. A convenient opportunity for diversion of pledged securities or other assets to an unauthorized user might be created at the time these assets are returned by a secured creditor.

Primary Audit Objectives:	
Existence	☒
Completeness	☒
Obligations	☒
Accuracy	☒
Cutoff	☒

Primary Audit Objectives:	
Existence	☒
Completeness	☒
Obligations	☒
Accuracy	☒
Cutoff	☒

Primary Audit Objectives:	
Existence	☒
Completeness	☒
Obligations	☒
Accuracy	☒
Cutoff	☒

Primary Audit Objectives:	
Completeness	☒
Obligations	☒
Valuation	☒

5. Perform Analytical Procedures or Data Analytics to Test the Reasonableness of Interest-Bearing Debt and Interest Expense.

One of the most effective ways to determine the overall reasonableness of interest-bearing debt is to examine the relationship between recorded interest expense and the average principal amount of debt outstanding during the year. If the client is paying interest on debt that is not recorded, this relationship will not be in line with the interest rate at which the client company should be able to borrow. Therefore, the auditors can use these procedures as a test of the *completeness* of recorded interest-bearing debt.

The auditors also compare the year-end amount of interest-bearing debt with the amount in the prior year's balance sheet. A similar comparison is made of interest expense for the current year and the preceding year.

While these procedures may be applied on an overall basis, data analytic techniques may be used to test the relationship between debt and interest expense individually for all outstanding obligations.

Primary Audit Objectives:	
Completeness	☒
Obligations	☒
Valuation	☒

6. Test the Valuation of Debt, Computation of Interest Expense, Interest Payable, and Amortization of Discount or Premium.

Unless management elects the fair value option, debt is valued at its outstanding face value plus or minus any unamortized premium or discount. To test valuation, the auditors test the amounts of amortization of debt premiums or discounts. In addition, the auditors test the accuracy of the client's computations of interest expense and interest payable, including examining paid checks supporting interest payments. An analysis of interest payments is another means of bringing to light any unrecorded interest-bearing liabilities.

The fair value option, as presented in Chapter 5, is available for companies that wish to value these financial liabilities at market value. As indicated in Chapter 5, depending upon the circumstances involved, valuation may be with observable inputs (e.g., market prices) or unobservable inputs (discounted cash flows). When the fair value option has been selected, the auditors should evaluate the propriety of the valuation techniques and the inputs.

Primary Audit Objective:	
Presentation	☒

7. Evaluate Whether Debt Provisions Have Been Met.

In the first audit of a client or upon the issuance of a new bond issue, the auditors will obtain a copy of the bond indenture for the permanent file. The indenture should be carefully studied, with particular attention to such points as the amount of bonds authorized, interest rates and dates, maturity dates, descriptions of property pledged as collateral, provisions for retirement or conversion, duties and responsibilities of the trustee, and any restrictions imposed on the borrowing company. For large organizations with many debt agreements, the auditors may use software to review agreements and identify provisions that may require review by the auditors.

The indenture provisions may require maintenance of a sinking fund, maintenance of stipulated minimum levels of working capital, and insurance of pledged property. The indenture also may restrict dividends to a specified proportion of earnings, limit management compensation, and prohibit additional long-term borrowing, except under stipulated conditions. The auditors will perform tests to evaluate whether the company is in compliance with these provisions. For example, the auditors will examine evidence of insurance coverage, vouch payments to the sinking fund, and compare the amounts of management compensation and dividends paid to amounts allowed by the agreements.

If the company has not complied fully with the requirements, the auditors should inform both the client and the client's legal counsel of the violation. In some cases of violation, the entire bond issue may become due and payable on demand and, hence, a current liability. When the client is in violation of an indenture provision and the penalty is to make the debt become payable upon demand, the client usually will be able to obtain a waiver of compliance with the provision. In other words, creditors often choose not to enforce contract terms fully. To enable the liability to be presented as long term, the waiver must waive compliance for a period of one year from the balance sheet date. Even if an appropriate waiver of compliance is obtained, the matter should be disclosed in the notes to the client's financial statements.



Illustrative Case

Violations of Debt Covenants

In the audit of a large construction company, the auditors found the client's working capital to be far below the minimum level stipulated in the indenture of long-term secured bonds payable. In addition, the client had allowed the required insurance coverage of pledged assets to lapse. These violations of the indenture were sufficient to cause the bond issue to become payable on demand.

Although the client agreed to reclassify the bond issue as a current liability and disclose the problem in the financial

statements, the auditors were unable to satisfy themselves that the client could meet the obligation if the bondholders demanded payment. Also, if the bondholders foreclosed on the pledged assets, the ability of the client to continue as a going concern would be questionable. Thus, even after the liability was reclassified as current, the auditors added an explanatory paragraph to their report referring to the uncertainty regarding the company's ability to meet its obligations and remain a going concern.

Auditors do not judge the legality of a bond issue; this is a problem for the client's attorneys. The auditors should be familiar, however, with the principal provisions of the federal Securities Act of 1933 and the corporate blue sky laws of the client's state of incorporation. They should determine that the client has obtained an attorney's opinion on the legality of the bond issuance. In doubtful cases, they should obtain representations from the client's legal counsel.

Primary Audit
Objective:

Presentation ☒

8. Trace Authority for Issuance of Debt to the Corporate Minutes.

The authority to issue debt generally lies with the board of directors. To determine that the bonds outstanding were properly authorized, the auditors should read the passages in the minutes of directors' (and stockholders') meetings concerning the issuance of debt. The minutes usually will cite the applicable sections of the corporate bylaws permitting the issuance of debt instruments and may also contain reference to the opinion of the company's counsel concerning the legality of the issue.

Primary Audit
Objective:

Presentation ☒

9. Review Notes Payable Paid or Renewed after the Balance Sheet Date.

If any of the notes payable outstanding at the balance sheet date are paid before completion of the audit engagement, such cash payments provide the auditors with additional evidence on the liability. Renewal of notes maturing shortly after the balance sheet date may alter the auditors' thinking as to the proper classification of these liabilities.

In the discussion of notes receivable in Chapter 11, emphasis was placed on the necessity of close scrutiny of loans to officers, directors, and affiliates because of the absence of arm's-length bargaining in these related party transactions. Similar emphasis should be placed on the examination of notes payable to insiders or affiliates, although the opportunities for self-dealing are more limited than with receivables. The auditors should scan the notes payable records for the period between the balance sheet date and the completion of the audit so that they may be aware of any unusual transactions, such as the reestablishment of an insider note that had been paid just prior to the balance sheet date.

Primary Audit
Objective:

Presentation ☒

10. Perform Procedures to Identify Notes Payable to Related Parties.

As has been the case in other portions of the audit, the auditors should perform procedures to determine that any related party debt is properly disclosed. Note here that the lower number of transactions makes discovery of such transactions less difficult than in accounts with a large number of transactions such as accounts payable.

Primary Audit
Objective:

Presentation ☒

11. Send Confirmation Letters to Financial Institutions to Obtain Information about Financing Arrangements.

Financing arrangements and transactions can be very complex, and the details of these arrangements and transactions must be adequately disclosed in the notes to the financial

FIGURE 15.2
Illustrative Letter for
Confirmation of Lines
of Credit

Wallace Manufacturing Inc. 1400 Main St. Los Angeles, CA 90015
January 31, 20X5 Mr. Richard M. Smith Senior Loan Officer First United Bank 2330 Fourth Ave. Los Angeles, CA 90010 Dear Mr. Smith: In connection with an audit of the financial statements of Wallace Manufacturing Inc. as of December 31, 20X4, and for the year then ended, we have advised our independent auditors of the information listed below, which we believe is a complete and accurate description of our line of credit from your financial institution as of the close of business on December 31, 20X4. Although we do not request or expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other lines of credit from your financial institution comes to your attention, please include such information below. 1. The company has available at your financial institution a line of credit totaling \$47 million. 2. The current terms of the line of credit are contained in the letter dated May 11, 20X2. 3. The amount of unused line of credit, subject to the terms of the related letter, at December 31, 20X4, was \$19 million. 4. The interest rate at the close of business on December 31, 20X4, was 9.2%. 5. There are no requirements for compensating balances in connection with this line of credit. Please confirm whether the information about the line of credit presented above is correct by signing below and returning this letter directly to our independent auditors, Warren & Clark, CPAs, 2100 Century Blvd., Los Angeles, CA 90053. Sincerely, Wallace Manufacturing, Inc. By: <u>Robert Barr</u> Robert Barr Controller ----- Dear Warren & Clark, CPAs: The above information regarding the line of credit agrees with the records of this financial institution. Although we have not conducted a comprehensive, detailed search of our records, no information about other lines of credit came to our attention. [Note exceptions below or in an attached letter.] _____ _____ _____ First United Bank By: <u>Richard Smith, Senior Loan Officer</u> <u>2/20/X5</u> (Officer and Title) (Date)

statements. If the auditors determine that additional evidence is needed to verify these details, they will send a *separate* confirmation letter to the financial institution. For example, confirmation letters may be used to obtain information about lines of credit, contingent liabilities, compensating balance arrangements, letters of credit, or futures contracts. These letters are signed by the client and specifically addressed to the client's loan officer or another official at the financial institution who is knowledgeable about the information. This expedites a response to the confirmation and enhances the quality of the evidence received. Figure 15.2 provides an example of a letter to confirm information about lines of credit.

Primary Audit Objective:

Presentation	☒

12. Evaluate Proper Financial Statement Presentation and Disclosure of Debt and Related Transactions.

Because of the interest of creditors in the current liability section of the balance sheet and the inferences that may be drawn from various uses of notes payable, adequate informative disclosure is extremely important. Classification of notes by types of payees, as well as by current or long-term maturity, is necessary. Notes payable to banks, notes payable to trade creditors, and notes payable to officers, directors, stockholders, and affiliates should be listed separately.

Secured liabilities and pledged assets should be cross-referenced to one another with an explanation in the notes to the financial statements. In the event of financial difficulties and dissolution, creditors expect to share in the assets in proportion to their respective claims; if certain assets, such as current receivables, have been pledged to one creditor, the risk to unsecured creditors is increased. Current liabilities should include not only those notes maturing within a period of 12 months (or a longer operating cycle) but also any installments currently payable on long-term obligations such as mortgages.

The essential point in balance sheet presentation of long-term liabilities is that they be adequately described, including details about the types of debt, amounts authorized and issued, interest rates, maturity dates, and any conversion or subordination features.

Long-Term Debt Payable in the Current Period

Long-term liabilities include all debts that will not be liquidated with the use of current assets. In other words, any bonds or notes falling due in the coming operating cycle that are to be paid from special funds or refinanced will be classified as long-term obligations regardless of maturity date. Before accepting a long-term classification for maturing obligations, auditors should satisfy themselves that the client has both the *intent* and the *ability* to refinance the obligation on a long-term basis. Intent and ability to refinance are demonstrated by the client through either (a) refinancing the obligation on a long-term basis before the issuance of the financial statements or (b) entering into a financing agreement by that date that clearly permits such refinancing. Any debt maturing currently and payable from current assets should be classified as a current liability.

Restrictions Imposed by Long-Term Debt Agreements

The major restrictions imposed on the company by long-term loan agreements are significant to the company's investors and creditors. Consequently, the nature of the restrictions should be clearly set forth in a note to the financial statements.

Unamortized Bond Premium or Discount

Unamortized premium should be added to the face amount of the bonds or debentures in the liability section of the balance sheet. Similarly, unamortized discount should be deducted from the face amount of the debt.

Time of Examination—Debt

Analysis of the ledger accounts for debt and interest expense takes very little time in most audits because of the small number of entries. Consequently, most auditors prefer to wait until the end of the year before analyzing these accounts.

Audit procedures intended to reveal any unrecorded liabilities cannot ordinarily be performed in advance of the balance sheet date. Such steps as the evaluation of compliance with debt provisions, tests of interest expense, and the investigation of notes paid or renewed shortly after the balance sheet date must necessarily await the close of the period being audited. The opportunities for performing audit work in advance of the balance sheet date are thus much more limited in the case of debt than for most of the asset groups previously discussed.

Equity Capital

Sources and Nature of Owners' Equity

Most of this section is concerned with the audit of stockholders' equity accounts of corporate clients; the audit of owners' equity in partnerships and sole proprietorships is discussed briefly near the end of the chapter.

LO 15-6

Describe the nature of equity accounts.

Owners' equity for corporate clients consists of capital stock accounts (preferred and common) and retained earnings. Balances in the capital stock accounts change when the corporation issues or repurchases stock. Transfer of ownership of shares from one shareholder to another does not affect the account balances. Retained earnings are normally increased by earnings and decreased by dividend payments. Additionally, a few journal entries (e.g., prior period adjustments) may directly affect retained earnings. Transactions in the owners' equity accounts are generally few in number but material in amount. No change may occur during the year in the capital stock accounts, and perhaps only one or two entries will be made to the retained earnings account.

The Auditors' Objectives in Auditing Owners' Equity

LO 15-7

Describe the auditors' objectives in the audit of equity accounts.

The auditors' *objectives* in the audit of owners' equity are to

1. Use the understanding of the client and its environment to consider *inherent risks*, including fraud risks, related to owners' equity.
2. Obtain an understanding of *internal control* over owners' equity.
3. Assess the risks of material misstatement and design tests of controls and substantive procedures that
 - a. Substantiate the *existence* of owners' equity and the *occurrence* of the related transactions.
 - b. Establish the *completeness* of recorded owners' equity.
 - c. Verify the *cutoff* of transactions affecting owners' equity.
 - d. Establish the proper *valuation* of owners' equity and the *accuracy* of transactions affecting owners' equity.
 - e. Determine that the *presentation* and *disclosure* of information about owners' equity are appropriate.

In conjunction with the audit of owners' equity accounts, the auditors will also obtain evidence about the related accounts of dividends payable and capital stock discounts and premiums.

Internal Control over Owners' Equity

LO 15-8

Obtain an understanding of the fundamental controls over capital stock and other types of equity accounts.

There are three principal elements of strong internal control over capital stock and dividends: (1) the proper authorization of transactions by the board of directors and corporate officers, (2) the segregation of duties in handling these transactions (preferably the use of independent agents for stock registration and transfer and for dividend payments), and (3) the maintenance of adequate records.

Control of Capital Stock Transactions by the Board of Directors

All changes in capital stock accounts should receive formal advance approval by the board of directors. The board of directors must determine the number of shares to be issued and the price per share; if an installment plan of payment is to be used, the board must prescribe the terms. If plant and equipment, services, or any consideration other than cash is to be accepted in payment for shares, the board of directors must establish the valuation on the noncash assets received. Transfers from retained earnings to the Capital Stock and Paid-in Capital accounts, as in the case of stock dividends, are initiated by action of the board. In addition, stock splits and changes in par or stated value of shares require formal authorization by the board.

Authority for all dividend actions rests with the directors. The declaration of a dividend must specify not only the amount per share but also the date of record and the date of payment.

Independent Registrar and Stock Transfer Agent

In appraising internal control over capital stock, the first question that the auditors consider is whether the corporation employs the services of an independent stock registrar and a stock transfer agent or handles its own capital stock transactions. Internal control is far stronger when the services of an independent stock registrar and a stock transfer

agent are utilized because the banks or trust companies acting in these capacities have the experience, the specialized facilities, and the trained personnel to perform the work in an expert manner. Moreover, by placing the responsibility for handling capital stock in separate and independent organizations, the corporation achieves to the fullest extent the internal control concept of separation of duties. The New York Stock Exchange and most other exchanges require that listed corporations utilize the services of an independent registrar.

The primary responsibility of the **stock registrar** is to avoid any overissuance of stock. The danger of overissuance is illustrated by the old story of a promoter who sold a 25 percent interest in a new corporation to each of 10 investors. To prevent such frauds, the registrar must make certain that the issuance of stock is properly controlled. Historically, control was exerted over the issuance of paper stock certificates related to stock transactions. Currently, paper stock certificates often are not issued and the control is focused on the associated electronic records. Many companies use a **direct registration system**, which allows electronic registration of securities in an investor's name. The system allows shares to be transferred between a transfer agent and stockbroker electronically; alternatively, if the company does not have a transfer agent, the company itself ("the issuer") may directly register the securities using the system.

Corporations with actively traded securities also employ independent **stock transfer agents**. Although the stock transfer agent maintains a record of the total shares outstanding, its primary responsibility is maintaining detailed stockholder records (name and address of each stockholder) and carrying out transfers of stock ownership, often through its direct registration system.

The Stock Certificate Book and Stockholders Ledger

Ordinarily, only relatively small clients issue paper stock certificates on a regular basis. In these clients, the board of directors usually assigns stock issuance functions to the secretary of the company. The board of directors should designate officers who are authorized to (1) sign stock certificates, (2) maintain records of stockholders, (3) maintain custody of unissued certificates, and (4) sign dividend checks. The stock certificates should be serially numbered by the printer, and from the time of delivery to the company until issuance, they should be in the exclusive custody of the designated officer. The signatures of two officers are generally required on stock certificates.

The certificates often are prepared in and torn from bound books called **stock certificate books**, with attached stubs similar to those in a checkbook. Each stub shows the certificate number and contains blank spaces for entering the number of shares represented by the certificate, the name of the stockholder, and the serial number of any previously issued certificate surrendered in exchange for the new one. Certificates should be issued in numerical sequence and not signed or countersigned until the time of issuance. When outstanding shares are transferred from one holder to another, the old certificate is surrendered to the company. The designated officer cancels the old certificate by perforating and attaching it to the corresponding stub in the certificate book.

The stock certificate book is not in itself an adequate record of the capital stock outstanding. The certificates appear in the book in serial number order, and a single stockholder may own several certificates listed at various places in the certificate book. A transfer journal may be used to record transfers of shares between shareholders. A **stockholders ledger** provides a separate record for each stockholder, thus making it possible to determine at a glance the total number of shares owned by any one person. This record may be used in compiling the list of dividend checks or for any other communication with shareholders.

Internal Control over Dividends

The nature of internal control over the payment of dividends, as in the case of stock issuance, depends primarily upon whether the company performs the function of dividend payment itself or utilizes the services of an independent dividend-paying agent. If an independent dividend-paying agent is used, the corporation will provide the agent with a certified copy of the dividend declaration and a check for the full amount of the dividend.

The bank or trust company serving as stock transfer agent is usually appointed to distribute the dividend because it maintains the detailed records of stockholders. The agent issues dividend checks to the individual stockholders and sends the corporation a list of the payments made. The use of an independent dividend-paying agent is to be recommended from the standpoint of internal control, as it materially reduces the possibility of fraud or error arising in connection with the distribution of dividends.

In a small corporation that does not use the services of a dividend-paying agent, the responsibility for payment of dividends is usually lodged with the treasurer and the secretary. After declaration of a dividend by the board of directors, the secretary prepares a list of stockholders as of the date of record, the number of shares held by each, and the amount of the dividend each is to receive. The total of these individual amounts is proved by multiplying the dividend per share by the total number of outstanding shares.

Dividend checks controlled by serial numbers are drawn payable to individual stockholders in the amounts shown on the list described above. If the stockholders ledger is maintained on a computer master file, the dividend checks may be prepared by the computer directly from this record. The stockholder list and dividend checks are submitted to the treasurer for approval and signature. The checks should be reconciled by the treasurer with the total of shares outstanding and mailed without again coming under control of the officer who prepared them.

Cash in the amount of the total dividend is then transferred from the general bank account to a separate dividend bank account. As the individual dividend checks are paid from this account and returned by the bank, they should be matched with the check stubs or marked *paid* in the dividend check register. A list of outstanding checks should be prepared monthly from the open stubs or open items in the check register. This list should agree in total with the balance remaining in the dividend bank account. Companies with numerous stockholders prepare dividend checks in machine-readable form so that the computer may perform the reconciliation of outstanding checks.

Audit Documentation for Owners' Equity

In addition to the lead schedule for owners' equity accounts, the auditors prepare an analysis of each equity account for the permanent file. A detailed analysis is essential for all aspects of a stock option plan: options authorized, issued, and outstanding. For a closely held corporation not served by a transfer agent, the auditors will often prepare for the permanent file a list of shareholders and the number of shares owned by each. In addition, documentation will include descriptions of internal control and the auditors' risk assessment.

Audit Plan—Capital Stock

The following procedures are typical of the procedures required in many engagements for the verification of capital stock:

LO 15-9

Describe further audit procedures for equity accounts.

1. Obtain an understanding of internal control over capital stock transactions.
2. Examine articles of incorporation, bylaws, and minutes for provisions relating to capital stock.
3. Obtain or prepare analyses of the capital stock accounts.
4. Account for all proceeds from stock issues.
5. Confirm shares outstanding with the independent registrar and stock transfer agent.
6. For a corporation acting as its own stock registrar and transfer agent, reconcile the stockholder records with the general ledger.
7. Determine that appropriate accounting is applied to employee stock compensation plans.
8. Determine that compliance with restrictions and preferences pertaining to capital stock and disclosures are appropriate.

Capital stock transactions are usually few in number; consequently, the auditors usually substantiate all transactions in audits of nonpublic companies. In public company integrated audits, the auditors will rely on controls because they must be tested to attest to internal control. In addition to the preceding steps, the auditors should determine the appropriate financial statement presentation of capital stock. This topic is discussed later in this chapter, along with the financial statement presentation of other elements of owners' equity.

1. Obtain an Understanding of Internal Control over Capital Stock Transactions.

Although the examination of capital stock consists primarily of substantive procedures, the auditors, even in the audits of nonpublic companies, should acquire an understanding of the client's procedures for authorizing, executing, and recording capital stock transactions. This may be achieved by preparing a written description or flowchart of the system or by filling in an internal control questionnaire. If the questionnaire approach is employed, typical questions to be answered might include the following: Does the company utilize the services of an independent registrar and stock transfer agent? Are stockholders ledgers and transfer journals maintained? Are entries in owners' equity accounts reviewed periodically by an appropriate officer?

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Completeness	☒

2. Examine Articles of Incorporation, Bylaws, and Minutes for Provisions Relating to Capital Stock.

In a first audit, copies of the articles of incorporation and bylaws obtained for the permanent file should be read carefully. The information required by the auditors for each issue of capital stock includes the number of shares authorized and issued; the par or stated value; dividend rates, if any; call and conversion provisions; stock splits; and stock options. The auditors will also review minutes of the meetings of directors and stockholders for authorizations of transactions related to the company's stock. By gathering evidence on these points, the auditors obtain assurance that capital stock transactions and dividend payments have been in accordance with legal requirements and specific authorizations by stockholders and directors. Also, they will be able to judge whether the balance sheet contains all necessary information to describe adequately the various stock issues and other elements of corporate capital.

Primary Audit Objectives:	
Valuation	☒
Accuracy	☒

3. Obtain or Prepare Analyses of the Capital Stock Accounts.

In an initial audit engagement, capital stock accounts should be analyzed from the beginning of the corporation to provide the auditors with a complete historical picture of corporate capital. Analysis of capital stock includes an appraisal of the nature of all changes and the vouching of these changes to the supporting documents and records. All changes in capital stock should bear the authorization of the board of directors.

The analyses of capital stock accounts may be prepared in a manner that permits additions during later audit engagements. After the initial audit, if the analyses are kept in the auditors' permanent file, all that will be necessary is to record the current period's increases and decreases and to vouch these transactions. The auditors then will have working papers showing all changes in capital stock from the inception of the corporation.

The auditors also should analyze the Treasury Stock account and prepare a list showing the number of shares of **treasury stock** on hand. If the company uses paper stock certificates, those certificates on hand then may be inspected. If the client uses a transfer agent and paper certificates are not available, the transactions should be confirmed with the transfer agent.

In their review of treasury stock transactions, the auditors should refer to permanent file copies of the minutes of directors' meetings to determine that (a) the acquisition or reissuance of treasury stock was authorized by directors and (b) the price paid or received was in accordance with prices specified by the board.

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Valuation	☒
Accuracy	☒

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Cutoff	☒

Primary Audit Objectives:	
Existence	☒
Occurrence	☒
Completeness	☒
Cutoff	☒

4. Account for All Proceeds from Stock Issues.

Closely related to the analyses of capital stock accounts is the audit procedure of accounting for the receipt and proper disposition of all funds derived from the issuance of capital stock. The proceeds should be traced to the cash records and bank statements. SEC registration statements and contracts with underwriters may also be available as evidence of the amounts received from stock issues.

When assets other than cash are received as consideration for the issuance of capital stock, the entire transaction requires careful study. Generally, the value of assets and services received in exchange for capital shares is established by action of the board of directors. The auditors should determine that these accounting estimates made by the client result in a reasonable valuation.

5. Confirm Shares Outstanding with the Independent Registrar and Stock Transfer Agent.

The number of shares issued and outstanding on the balance sheet date may be confirmed by direct communication with the independent registrar and stock transfer agent (often the same organization). The confirmation request should be written by the client on the client's letterhead, but it should be mailed by the auditors. Confirmation replies should be sent directly to the auditors, not to the client. All information contained in these replies should be traced to the corporate records. It is essential that the general ledger controlling accounts agree with the amount of stock issued as reported by the independent registrar and stock transfer agent. Because of the strong controls usually maintained over stock transactions, it is not customary to communicate with individual stockholders in establishing the number of shares outstanding.

6. For a Corporation Acting as Its Own Stock Registrar and Transfer Agent, Reconcile the Stockholder Records with the General Ledger.

When a corporation acts as its own transfer agent and registrar and issues paper stock certificates, the auditors should adopt procedures to obtain evidence that is not available by direct confirmation with outside parties. These procedures include (a) accounting for stock certificate numbers, (b) examining canceled certificates, and (c) reconciling the stockholders ledger and stock certificate book with the general ledger.

The audit working papers should include a record of the last certificate number issued during the year. Reference to the working papers for the preceding audit, combined with the verification of certificate numbers issued during the current period, will enable the auditors to account for all certificates by serial number.

A working paper prepared during the auditors' examination of the stock certificate book of a small closely held corporation is designed to be utilized during several audits; it may be retained in the permanent file or forwarded to successive current files. Additionally, it is desirable for the auditors to inspect the unissued certificates to determine that all certificates purported to be unissued are actually on hand and blank.

Adequate internal control for corporations utilizing paper stock certificates requires that all canceled stock certificates be perforated or marked in a manner precluding the possibility of further use. Auditors will examine all canceled stock certificates on hand, noting in particular that they have been voided. The general ledger account for capital stock shows the total par value or stated value of all shares outstanding, plus any treasury shares. The stockholders ledger includes an account for each stockholder. The stock certificate book contains all canceled certificates and also open stubs for outstanding certificates. The auditors should reconcile these three records (general ledger control account, stockholders ledger, and stock certificate book) to establish the amount of outstanding stock and to rule out the possibility of an overissuance of shares.

A trial balance of the subsidiary stockholder records may be obtained from the client or prepared by the auditors and compared with the general ledger controlling account.



Illustrative Case

Backdating of Stock Options

Several years ago, financial headlines revealed that a number of companies had engaged in “backdating” of stock option grants to officers and employees. Some of these companies announced restatements of previously issued financial statements as a result of the practice. The PCAOB has indicated that auditors should be alert to

the risk that a company may not have properly accounted for stock options and, as a result, may have materially misstated its financial statements. In cases where the risk of misstatement is significant, the auditors should react to the risk by considering assigning more experienced staff to the audit and evaluating the nature of the audit procedures to be performed for the options.

In conjunction with this procedure, the total shares outstanding, as shown by the stock certificate book stubs, should also be reconciled with the control account and with the subsidiary trial balance. These procedures assure the auditors of the accuracy of the ledger account balances for capital stock.

Primary Audit Objectives:	
Valuation	☒
Accuracy	☒
Presentation	☒

7. Determine That Appropriate Accounting Is Applied to Employee Stock Compensation Plans.

Many corporations grant stock options or other similar instruments to officers and employees through incentive-type compensation plans. Accounting standards now require companies to recognize the compensation cost related to these awards. Specifically, the compensation cost is measured as the fair value of the options on the date they are granted to the employee. This cost is then recognized as compensation expense over the period in which the options vest.

The accounting for these instruments at fair value presents a particular challenge for the auditors. Because options are not traded on a market, the fair values of the options are determined by using option pricing models, such as the Black-Scholes and the binomial models. Estimates of fair value or variability of stock prices are often determined by reference to the behavior of stock and option prices of comparable companies. The auditors should determine that the assumptions underlying the estimates of fair value are reasonable. In addition, they should obtain evidence that the computations are accurate. Chapter 5 describes the guidance for auditing financial statement items that are measured at fair value. In this area, the auditors may decide to use the work of a specialist.

Primary Audit Objective:	
Presentation	☒

8. Determine That Compliance with Restrictions and Preferences Pertaining to Capital Stock and Disclosures Are Appropriate.

When *stock options* are granted, the corporation must hold a portion of the authorized but unissued stock in reserve so that it will be in a position to fulfill the option agreements. Similarly, corporations with convertible debentures or convertible preferred stock outstanding must hold in reserve a sufficient number of common shares to meet the demands of preferred stockholders and debenture holders who may elect to convert their securities into common stock.

The auditors should become thoroughly familiar with the terms of any stock options and stock purchase plans and with the conversion features of debenture bonds and preferred stock so that they can determine appropriate measurement and adequate disclosure of these agreements. The auditors should also verify the shares issued during the year through conversion or exercise of stock options and should ascertain that the number of shares held in reserve at the balance sheet date does not exceed the corporation’s authorized but unissued stock.

Retained Earnings and Dividends

Audit work on retained earnings and dividends includes two major steps: (1) the analysis of retained earnings and any appropriations of retained earnings and (2) the review of dividend procedures for both cash and stock dividends.

On a first-year audit, the analysis of retained earnings and any appropriations of retained earnings should cover the entire history of these accounts. Such an analysis is prepared for the permanent file and is updated during each annual audit. Credits to the Retained Earnings account ordinarily represent amounts of net income transferred from the Income Summary account. Debits to the Retained Earnings account ordinarily include entries for net losses, cash and stock dividends, and the creation or enlargement of appropriated reserves. Appropriations of retained earnings require specific authorization by the board of directors. The only verification necessary for these entries is to ascertain that the dates and amounts correspond to the actions of the board.

In the verification of cash dividends, the auditors usually will perform the following steps:

1. Determine the dates and amounts of dividends authorized.
2. Verify the amounts paid.
3. Determine the amount of any preferred dividends in arrears.
4. Review the treatment of unclaimed dividend checks.

The auditors' analysis of dividend declarations may reveal the existence of cash dividends declared but not paid. These dividends must be shown as liabilities in the balance sheet. The auditors also may review the procedures for handling unclaimed dividends and ascertain that these items are recognized as liabilities. The amount of any accumulated dividends in arrears on preferred stock should be computed. If a closely held company has irregular dividend declarations or none at all, the auditors should consider whether the federal penalty surtax on reasonably accumulated retained earnings might be assessed. In the verification of stock dividends, there is an additional responsibility of determining that the proper amounts have been transferred from retained earnings to capital stock and paid-in capital accounts for both large and small stock dividends.

Financial Statement Presentation of Stockholders' Equity

The presentation of capital stock in the balance sheet should include a complete description of each issue. Information to be disclosed includes the title of each issue; par or stated value; dividend rate, if any; dividend preference; conversion and call provisions; number of shares authorized, issued, and in treasury; dividends in arrears, if any; and shares reserved for stock options or for conversions.

Treasury stock preferably is shown in the stockholders' equity section, at cost, as a deduction from the combined total of paid-in capital and retained earnings. In many states, an amount of retained earnings equivalent to the cost of the treasury shares must be restricted. A note to the financial statements discloses this restriction.

Changes in retained earnings during the year may be shown in a separate statement or combined with the income statement. A combined statement of income and retained earnings often is presented. In this form of presentation, the amount of retained earnings at the beginning of the year is added to the net income figure, dividends paid are subtracted from the subtotal, and the final figure represents the new balance of retained earnings.

One of the most significant points to consider in determining the presentation of retained earnings in the balance sheet is the existence of any restriction on the use of this retained income. Agreements with banks, bondholders, and other creditors very commonly impose limitations on the payment of dividends. These restrictions must be fully disclosed in the notes to financial statements.

Time of Examination—Stockholders' Equity

The transactions involving stockholders' equity accounts generally are few in number but material in amount. Because so few transactions occur, it usually is efficient to make the analysis after the close of the period. In the first audit of a new client, however, some preliminary work can be done in terms of obtaining and reviewing copies of the articles of incorporation and bylaws and analyzing the capital accounts.

For a continuing client, the auditors will often find that audit time required will be small in relation to the dollars in these accounts and much less than is required for assets, liabilities, revenue, or expense. Thus, while the capital stock account often has a larger balance than the cash account, the audit work required for capital stock is usually far less.

Audit of Partnerships and Sole Proprietorships

Perhaps the most common reason for a small business to arrange for an independent audit is the need for audited financial statements in order to obtain a bank loan. Often, when approached by the owners of a small business applying for a loan, a banker will request audited financial statements as an aid to reaching a decision on the loan application.

Procedures for the Audit of Partners' Accounts

A most significant document underlying the partnership form of organization is the partnership contract. The auditors are particularly interested in determining that the distribution of net income has been carried out in accordance with the profit-sharing provisions of the partnership contract. Maintenance of partners' capital accounts at prescribed levels and restriction of drawings by partners to specified amounts are other points often covered in the contract; compliance with these clauses should be verified by the auditors in determining the propriety of the year's entries in the capital accounts. Partners' loan accounts also require reference to the partnership contract to determine the treatment intended by the partners.

Occasionally, the auditors may find that a partnership is operating without any written agreement of partnership. This situation raises a question of whether profits have been divided in accordance with the understanding existing between the partners. For their own protection, the auditors may wish to obtain from each partner a written statement confirming the balance in their capital account and approval of the method used in dividing the year's earnings. They may also suggest that the firm develop a written partnership agreement.

Procedures for the Audit of Sole Proprietorships

In general, the same principles described for the audit of corporate capital are applicable to the examination of the capital accounts and drawing accounts of a sole proprietorship or partnership. Analyses are made of all proprietorship accounts from the beginning of the business; the initial capital investment and any additions are traced to the cash and asset records; and the net income or loss for the period and any withdrawals are verified. In the case of a sole proprietorship, a common source of difficulty is the practice of intermingling business and personal transactions, making it necessary for the auditors to segregate personal net worth from business capital. Adjustments may also be required to transfer from expense accounts to the owner's drawing account any personal expenditures paid with company funds.

Chapter Summary

The details of the audit of long-term debt and equity accounts were discussed in this chapter. The chapter includes a description of the controls for these types of accounts and the audit procedures that auditors use to substantiate long-term debt and equity accounts. To summarize:

1. The financing cycle involves those activities of the company that are designed to obtain capital funds. It typically involves the issuance and repayment of debt and equity, as well as payment of interest and dividends. A primary concern for both of these types of transactions is proper authorization by the appropriate official in the company or by the board of directors.

2. Control over the issuance of bonds by a company is enhanced when an independent trustee represents the interest of the bondholders. The responsibilities of the trustee include monitoring the company's compliance with the requirements of the bond agreement and processing the payments of interest and principal to individual bondholders.
3. Capital stock transactions are best controlled by employing a registrar/transfer agent who monitors the issuance of the company's stock and handles transfers of shares between investors. In smaller companies, capital stock is controlled through the maintenance of a stock certificate book and a stockholders ledger.
4. After the auditors obtain an understanding of the client and its environment, including internal control over the financing cycle, they will often perform only limited tests of controls because of the limited number of transactions typically involved. In audits of nonpublic companies, it is usually more efficient to assess control risk at a high level and perform detailed substantive procedures for transactions. Internal controls must be tested in an integrated audit of a public company.
5. In the audit of debt, the auditors' primary substantive procedures will include vouching selected transactions occurring during the period, examining debt agreements, confirming balances and terms, and evaluating compliance with restrictive covenants.
6. The auditors' primary substantive procedures for equity transactions will typically include vouching the major equity transactions occurring during the period, confirming the number of shares outstanding with the registrar, and evaluating the company's compliance with stock option plan requirements and other restricting agreements.

Key Terms Introduced or Emphasized in Chapter 15

Debenture bond (704) An unsecured bond, dependent upon the general credit of the issuer.

Direct registration system (714) A system that allows electronic direct registration of securities in an investor's name on the books of the transfer agent or the company itself ("the issuer"), and allows shares to be transferred between a transfer agent and a stockbroker electronically.

Sinking fund (708) Cash or other assets set aside for the retirement of a debt.

Stock certificate book (714) A book of serially numbered certificates with attached stubs. Each stub shows the corresponding certificate number and provides space for entering the number of shares represented by the certificate, the name of the shareholder, and the serial number of the certificate surrendered in exchange for the new one. Surrendered certificates are canceled and replaced in the certificate book.

Stock registrar (714) An institution charged with responsibility for avoiding overissuance of a corporation's stock. Every new certificate must be presented to the registrar for examination and registration before it is issued to a stockholder.

Stock transfer agent (714) An institution responsible for maintaining detailed records of shareholders and handling transfers of stock ownership.

Stockholders ledger (714) A record showing the number of shares owned by each stockholder. This is the basic record used for preparing dividend payments and other communications with shareholders.

Treasury stock (716) Shares of its own stock acquired by a corporation for the purpose of being reissued at a later date.

Trust indenture (704) The formal agreement between bondholders and the issuer as to the terms of the debt.

Review Questions

- 15-1. What does the trust indenture used by a corporation in creating long-term bonded indebtedness have to do with the payment of dividends on common stock?
- 15-2. Long-term creditors often insist upon placing certain restrictions upon the borrowing company for the term of the loan. Give three examples of such restrictions, and indicate how each restriction protects the long-term creditor.
- 15-3. Most corporations with bonds payable outstanding utilize the services of a trustee. What relation, if any, does this practice have to the maintenance of adequate internal control?
- 15-4. What information should be requested by the auditors from the trustee responsible for an issue of debentures payable?

- 15-5. Palmer Company has issued a number of notes payable during the year, and several of these notes are outstanding at the balance sheet date. What sources of information should the auditors use in preparing a working paper analysis of the notes payable?
- 15-6. Is the confirmation of notes payable usually correlated with any other specific phase of the audit? Explain.
- 15-7. What is the principal reason for testing the reasonableness of the Interest Expense account in conjunction with the verification of notes payable?
- 15-8. In addition to verifying the recorded liabilities of a company, the auditors should also give consideration to the possibility that other unrecorded liabilities exist. What specific steps may be taken by the auditors to determine that all their client's interest-bearing liabilities are recorded?
- 15-9. Audit procedures for examination of accounts receivable and notes receivable often include investigation of selected transactions occurring after the balance sheet date as well as transactions occurring during the year under audit. Are the auditors concerned with notes payable transactions subsequent to the balance sheet date? Explain.
- 15-10. "Auditors are not qualified to pass on the legality of a bond issue; this is a question for the company's attorneys. It is therefore unnecessary for the auditors to inspect the bond indenture." Criticize the quotation.
- 15-11. Mansfield Corporation has outstanding an issue of 30-year bonds payable. There is no sinking fund for these bonds. Under what circumstances, if any, should this bond issue be classified as a current liability?
- 15-12. Two assistant auditors were assigned by the auditor-in-charge to the verification of long-term liabilities. Some time later, they reported to the auditor-in-charge that they had determined that all long-term liabilities were properly recorded and that all recorded long-term liabilities were genuine obligations. Does this determination constitute a sufficient examination of long-term liabilities? Explain.
- 15-13. Compare the auditors' examination of owners' equity with their work on assets and current liabilities. Among other factors to be considered are the relative amounts of time involved and the character of the transactions to be inspected.
- 15-14. What do you consider to be the most important control a corporation can adopt with respect to capital stock transactions?
- 15-15. What is the primary responsibility of an independent registrar with respect to capital stock?
- 15-16. In the audit of a small corporation that issues paper stock certificates and does not utilize the services of an independent stock registrar and stock transfer agent, what use is made of the stock certificate book by the auditors?
- 15-17. Describe the ordinary role of paper stock certificates when a direct registration system (DRS) is utilized.
- 15-18. You have been retained to perform an audit of Valley Products, a small corporation that has not been audited during the previous 10 years of its existence. How will your work on the Capital Stock account in this initial audit differ from that required in a repeat engagement?
- 15-19. Your new client, Black Angus Valley Ranch, is a small corporation with fewer than 100 stockholders. It does not utilize the services of an independent stock registrar or transfer agent. For your first audit, you want to obtain or prepare a year-end list of stockholders showing the number of shares owned by each. From what source or record should this information be obtained? Explain.
- 15-20. Corporations sometimes issue their own capital stock in exchange for services and various assets other than cash. As an auditor, what evidence would you look for to determine the propriety of the values used in recording such transactions?
- 15-21. In your second annual audit of a corporate client, you find a new account in the general ledger called Treasury Stock, which has a balance of \$306,000. Describe the procedures you would follow to verify this item.
- 15-22. In auditing the financial statements of Foster Company, you observe a debit entry for \$200,000 labeled as Dividends in the Retained Earnings account. Explain in detail how you would verify this entry.
- 15-23. Name three situations that might place a restriction on retained earnings, limiting or preventing dividend payments. Explain how the auditors might become aware of each such restricting factor.
- 15-24. Comment on the desirability of audit work on the owners' equity accounts before the balance sheet date.

- 15–25. Delta Company has issued stock options to four of its officers, permitting them to purchase 5,000 shares each of common stock at a price of \$25 per share at any time during the next five years. The president asks you what effect, if any, the granting of the options will have upon the balance sheet presentation of the stockholders' equity accounts.
- 15–26. What errors are commonly encountered by the auditors in their examination of the capital and drawing accounts of a sole proprietor?

Questions Requiring Analysis

LO 15-1, 5

LO 15-1, 4, 5

LO 15-1, 5

LO 15-1, 4, 5



LO 15-6, 7, 8, 9

Select questions are available with Connect



- 15–27. The only long-term liability of Range Corporation is a note payable for \$1 million secured by a mortgage on the company's plant and equipment. You have audited the company annually for the three preceding years, during which time the principal amount of the note has remained unchanged. The maturity date is 10 years from the current balance sheet date. You are informed by the president of the company that all interest payments have been made promptly in accordance with the terms of the note. Under these circumstances, what audit work, if any, is necessary with respect to this long-term liability during your present year-end audit?
- 15–28. During your annual audit of Walker Distributing Co., your assistant, Jane Williams, reports to you that, although a number of entries were made during the year in the general ledger account Notes Payable to Officers, she decided that it was not necessary to audit the account because it had a zero balance at year-end.
Do you agree with your assistant's decision? Discuss.
- 15–29. You are engaged in the audit of the financial statements of Armada Corporation for the year ended August 31, 20X0. The balance sheet, reflecting all your audit adjustments accepted by the client to date, shows total current assets, \$8,000,000; total current liabilities, \$7,500,000; and stockholders' equity, \$1,000,000. Included in current liabilities are two unsecured notes payable—one payable to United National Bank in the amount of \$900,000 due October 31, 20X0; the other payable to First State Bank in the amount of \$800,000 due September 30, 20X0. On September 30, the last scheduled date for your audit fieldwork, you learn that Armada Corporation is unable to pay the \$832,000 maturity value of the First State Bank note, that Armada executives are negotiating with First State Bank for an extension of the due date of the note, and that nothing definite has been decided as to the extension.
- Should this situation be disclosed in the notes to Armada Corporation's August 31 financial statements?
 - After the question of financial statement disclosure has been resolved to the auditors' satisfaction, might this situation have any effect upon the audit report?
- 15–30. You are retained by Columbia Corporation to audit its financial statements for the fiscal year ended June 30. Your consideration of internal control indicates a fairly satisfactory condition, although there are not enough employees to permit an extensive separation of duties. The company is one of the smaller units in its industry, but it has realized net income of about \$500,000 in each of the last three years.
Near the end of your fieldwork, you overhear a telephone call received by the president of the company while you are discussing the audit with him. The telephone conversation indicates that on May 15 of the current year, the Columbia Corporation made an accommodation endorsement of a 60-day \$430,000 note issued by a major customer, Brill Corporation, to its bank. The purpose of the telephone call from Brill was to inform your client that the note had been paid at the maturity date. You had not been aware of the existence of the note before overhearing the telephone call.
- From an ethical standpoint, do you think the auditors would be justified in acting on information acquired in this manner?
 - Should the balance sheet as of June 30 disclose the contingent liability? Give reasons for your answer.
 - Prepare a list of auditing procedures that might have brought the contingency to light. Explain fully the likelihood of detection of the accommodation endorsement by each procedure listed.
- 15–31. Valley Corporation established a stock option plan for its officers and key employees this year. Because the options granted have a higher option price than the stock's current market price, the company has not recognized any cost for the options in the financial statements. However, a note to the financial statements includes all required disclosures.

- a. Do you believe that Valley's management has appropriately accounted for the stock option plan? Explain your answer.
- b. What responsibility do the auditors have for the information in the notes to the financial statements?
- c. List the audit procedures, if any, that you believe should be applied to the stock option plan.

Objective Questions

LO 15-2

15–32. Multiple Choice Questions

Select the best answer choice for each of the following, and justify your selection in a brief statement.

- a. Which of the following is *least* likely to be an audit objective for debt?
 - (1) Determine the existence of recorded debt.
 - (2) Establish the completeness of recorded debt.
 - (3) Determine that the client has rights to receive proceeds relating to the redemption of debt.
 - (4) Determine that the valuation of debt is in accordance with generally accepted accounting principles.

LO 15-5

- b. The auditors would be most likely to find unrecorded long-term liabilities by analyzing:
 - (1) Interest payments.
 - (2) Discounts on long-term liabilities.
 - (3) Premiums on long-term liabilities.
 - (4) Recorded long-term liability accounts.

LO 15-1, 5

- c. A likely reason that consideration of client compliance with debt provisions is important to an audit is that violation of such debt provisions may affect the total recorded:
 - (1) Number of debt restrictions.
 - (2) Current liabilities.
 - (3) Long-term assets.
 - (4) Capital stock.

LO 15-6, 8, 9

- d. A transfer agent and a registrar are most likely to provide the auditor with evidence on:
 - (1) Restrictions on the payment of accounts payable.
 - (2) Shares issued and outstanding.
 - (3) Preferred stock liquidation value.
 - (4) Transfers occurring between management and related parties.

LO 15-5, 9

- e. The audit procedure of confirmation is least appropriate with respect to:
 - (1) The trustee of an issue of bonds payable.
 - (2) Holders of common stock.
 - (3) Holders of notes receivable.
 - (4) Holders of notes payable.

LO 15-6, 9

- f. When a client uses paper stock certificates, an auditor is most likely to trace treasury stock purchase transactions to the:
 - (1) Numbered stock certificates on hand.
 - (2) Articles of incorporation.
 - (3) Year's interest expense.
 - (4) Minutes of the audit committee.

LO 15-1, 6

- g. In the continuing audit of a manufacturing company of medium size, which of the following areas would you expect to require the *least* amount of audit time?
 - (1) Owners' equity.
 - (2) Revenue.
 - (3) Assets.
 - (4) Liabilities.

LO 15-1, 4, 5

- h. The auditors can best verify a client's bond sinking fund transactions and year-end balance by:
- (1) Recomputation of interest expense, interest payable, and amortization of bond discount or premium.
 - (2) Confirmation with individual holders of retired bonds.
 - (3) Confirmation with the bond trustee.
 - (4) Examination and count of the bonds retired during the year.

LO 15-2, 5

- i. The auditors' plan for the examination of long-term debt should include steps that require the:
- (1) Verification of the existence of the bondholders.
 - (2) Examination of copies of debt agreements.
 - (3) Inspection of the accounts payable subsidiary ledger.
 - (4) Investigation of credits to the bond interest income account.

LO 15-1, 4

- j. All corporate capital stock transactions should ultimately be traced to the:
- (1) Minutes of the board of directors.
 - (2) Cash receipts journal.
 - (3) Cash disbursements journal.
 - (4) Numbered stock certificates.

LO 15-7, 9

- k. Which of the following is *most* likely to be an audit objective in the audit of owners' equity?
- (1) Establish that recorded owners' equity includes all long-term debt and equity balances.
 - (2) Determine that common stock is valued at current market value.
 - (3) Determine that the presentation and disclosure of owners' equity are appropriate.
 - (4) Determine that the existence of recorded owner's equity is in conformity with equity accounting rule valuations.

LO 15-9

- l. In an audit of a sole proprietorship, a common difficulty is lack of:
- (1) Segregation of personal net worth and business capital.
 - (2) Availability of the owner.
 - (3) Agreement as to the distribution between retained earnings and owners' capital.
 - (4) Proper measures of dividends.

LO 15-4

- m. Which of the following questions would an auditor most likely include on an internal control questionnaire for notes payable?
- (1) Are assets that collateralize notes payable critically needed for the entity's continued existence?
 - (2) Are two or more authorized signatures required on checks that repay notes payable?
 - (3) Are the proceeds from notes payable used for the purchase of noncurrent assets?
 - (4) Are direct borrowings on notes payable authorized by the board of directors?

LO 15-8

- n. The primary responsibility of a bank acting as registrar of capital stock is to:
- (1) Ascertain that dividends declared do *not* exceed the statutory amount allowable in the state of incorporation.
 - (2) Account for stock certificates by comparing the total shares outstanding to the total in the shareholders' subsidiary ledger.
 - (3) Act as an independent third party between the board of directors and outside investors concerning mergers, acquisitions, and the sale of treasury stock.
 - (4) Verify that stock is issued in accordance with the authorization of the board of directors and the articles of incorporation.

LO 15-8

- o. When a client uses paper stock certificates, canceled stock certificates should:
- (1) Be defaced to prevent reissuance and attached to their corresponding stubs.
 - (2) Not be defaced but segregated from other stock certificates and retained in a canceled certificates file.
 - (3) Be destroyed to prevent fraudulent reissuance.
 - (4) Be defaced and sent to the secretary of state.

LO 15-5

- p.* An auditor most likely would inspect loan agreements under which an entity's inventories are pledged to support management's financial statement assertion of:
- (1) Presentation and disclosure.
 - (2) Valuation or allocation.
 - (3) Existence or occurrence.
 - (4) Completeness.

LO 15-8

- q.* An auditor usually obtains evidence of stockholders' equity transactions by reviewing the entity's:
- (1) Minutes of board of directors meetings.
 - (2) Transfer agent's records.
 - (3) Canceled stock certificates.
 - (4) Treasury stock certificate book.

- LO 15-1, 5, 6, 8** 15–33. Match the following definitions (or partial definitions) to the appropriate term. Each term may be used once or not at all.

Definition (or Partial Definition)	Term
<i>a.</i> An institution charged with responsibility for avoiding overissuance of a corporation's stock	1. Common stock
<i>b.</i> An institution responsible for maintaining detailed records of shareholders and handling changes of ownership of stock ownership	2. Debenture bond
<i>c.</i> Cash or other assets set aside for the retirement of a debt	3. Direct registration system
<i>d.</i> Shares of its own stock acquired by a corporation for the purpose of being reissued at a later date	4. Sinking fund
<i>e.</i> The formal agreement between bondholders and the issuer as to the terms of the debt	5. Stock certificate book
<i>f.</i> A system that allows electronic registration and transfer of securities in an investor's name	6. Stock certificate holder
	7. Stock registrar
	8. Stock transfer agent
	9. Treasury stock
	10. Trust indenture

Problems

LO 15-1, 2, 5

- 15–34. Your client, Summerford Inc., has a debt agreement with Valley City Bank that includes a number of restrictions and covenants. Violation of any restriction or covenant results in the entire amount of the debt becoming due immediately. For each of the following, provide audit procedures that will address whether Summerford has met the restriction or covenant.
- a.* A current ratio of at least 1.5 to 1 must be maintained at year-end.
 - b.* No dividends may be paid in years in which there is a net loss. When there is net income, no more than one-half of the net income may be paid out in dividends.
 - c.* The accounts receivable and inventory serve as security on the loan.
 - d.* The total of the president's and vice president's salaries may not exceed \$800,000 during the duration of the loan.
 - e.* Monthly payments as per the agreement are due by the 10th of the following month.

LO 15-1, 2, 3, 4, 5

- 15–35. Robert Hopkins was the senior office employee at the Griffin Equipment Company. He enjoyed the complete confidence of the owner, William Barton, who devoted most of his attention to sales, engineering, and production problems. All financial and accounting matters were entrusted to Hopkins, whose title was office manager. Hopkins had two assistants, but their only experience in accounting and financial work had been gained under Hopkins's supervision. Barton had informed Hopkins that it was his responsibility to keep him (Barton) informed on the financial position and operating results of the company but not to bother him with details.



The company was short of working capital and would occasionally issue notes payable in settlement of past-due open accounts to suppliers. The situations warranting the issuance of notes were decided upon by Hopkins, and the notes were drawn by him for signature by Barton. Hopkins was aware of the weakness in internal control and finally devised a scheme for defrauding the company through understating the amount of notes payable outstanding. He prepared a note in the amount of \$24,000 payable to a supplier to whom several invoices were

past due. After securing Barton's signature on the note and mailing it to the creditor, Hopkins entered the note in the Notes Payable account of the general ledger as \$4,000, with an offsetting debit of \$4,000 to Accounts Payable. Subsequently, when funds became available to the company, he paid the \$20,000 of accounts payable that remained on the books.

Several months later when the note matured, a check for \$24,000 plus interest was issued and properly recorded, including a debit of \$24,000 to the Notes Payable account. Hopkins then altered the original credit in the account by changing the figure from \$4,000 to \$24,000. He also changed the original debit to Accounts Payable from \$4,000 to \$24,000. This alteration caused the Notes Payable account to have a balance in agreement with the total of other notes outstanding. To complete the fraud, Hopkins called the supplier to whom the check had been sent and explained that the check should have been for only \$4,000 plus interest.

Hopkins explained to the supplier that the note of \$24,000 originally had been issued in settlement of a number of past-due invoices, but that while the note was outstanding, checks had been sent in payment of all the invoices. "In other words," said Hopkins over the telephone, "we made the mistake of giving you a note for those invoices and then going ahead and sending you checks for them as soon as our cash position had improved. Then we paid the note at maturity. So please excuse our mistakes and return the overpayment."* After reviewing the record of invoices and checks received, the supplier agreed he had been overpaid by \$20,000 plus interest and promptly sent a refund, which Hopkins abstracted without making any entry in the accounts.

- a. Assuming that an audit by CPAs was made while the note was outstanding, do you think that the \$20,000 understatement of the Notes Payable account would have been detected? Explain fully the reasoning underlying your answer.
- b. If the fraud was not discovered while the note was outstanding, do you think that an audit subsequent to the payment of the note would have disclosed the fraud? Explain.
- c. What controls would you recommend for Griffin Equipment Company to avoid fraud of this type?

- LO 15-6, 8, 9** 15-36. You have received confirmations from the transfer agent and the registrar of Lowe Company as to the number of authorized and outstanding shares as of December 31, 20X1, Lowe's year-end.

- a. Which financial statement assertions do these confirmations most directly address?
- b. Provide a listing of additional auditing procedures likely to be necessary in the audit of Lowe's common stock outstanding.

- LO 15-6, 8, 9** 15-37. You are engaged in the audit of Phoenix Corp., a new client, at the close of its first fiscal year, April 30, 20X1. The accounts had been closed before the time you began your year-end fieldwork.

You review the following stockholders' equity accounts in the general ledger:

Capital Stock			
		5/1/X0 CR1	500,000
		4/28/X1 J12-5	50,000
Paid-in Capital in Excess of Stated Value			
		5/1/X0 CR1	250,000
		2/2/X1 CR10	2,500
Retained Earnings			
4/28/X1 J12-5	50,000	4/30/X1 J12-14	800,000
Treasury Stock			
9/14/X0 CP5	80,000	2/2/X1 CR10	40,000
Income Summary			
4/30/X1 J12-13	5,200,000	4/30/X1 J12-12	6,000,000
4/30/X1 J12-14	800,000		

* Robert Hopkins

Other information in your working papers includes the following:

1. Phoenix's articles of incorporation, filed April 17, 20X0, authorized 100,000 shares of no-par-value capital stock.
2. Directors' minutes include the following resolutions:
 - 4/18/X0 Established \$50 per share stated value for capital stock.
 - 4/30/X0 Authorized issue of 10,000 shares to an underwriting syndicate for \$75 per share.
 - 9/13/X0 Authorized acquisition of 1,000 shares from a dissident holder at \$80 per share.
 - 2/1/X1 Authorized reissue of 500 treasury shares at \$85 per share.
 - 4/28/X1 Declared 10 percent stock dividend, payable May 18, 20X1, to stockholders of record May 4, 20X1.
3. The following costs of the May 1, 20X0, and February 2, 20X1, stock issuances were charged to the named expense accounts: Printing Expense, \$2,500; Legal Fees, \$17,350; Accounting Fees, \$12,000; and SEC Fees, \$150.
4. Market values for Phoenix Corp. capital stock on various dates were

9/13/X0	\$78.50	2/2/X1	\$85.00
9/14/X0	\$79.00	4/28/X1	\$90.00
5. Phoenix Corp.'s combined federal and state income tax rates total 55 percent.
 - a. Prepare the necessary adjusting journal entries at April 30, 20X1.
 - b. Prepare the stockholders' equity section of Phoenix Corp.'s April 30, 20X1, balance sheet.

Auditing Operations and Completing the Audit

This chapter presents information about the manner in which auditors examine the client's income statement accounts and the procedures and considerations involved in completing the audit engagement. These procedures and judgments, completed at or near the last day of fieldwork, are important in determining the nature and content of the auditors' report.

Auditing Operations

Today, with great emphasis being placed upon corporate earnings as an indicator of the health and well-being of corporations as well as of the overall economy, the income statement is of fundamental importance to management, stockholders, creditors, employees, and the government. The earnings of a corporation are a major input into the projection of future cash flows for the corporation, which determines its value and stock price. In addition, the relative level of corporate earnings is often a key factor in the determination of such issues as wage negotiations, income tax rates, subsidies, and government fiscal policies. In fact, accountants generally agree that the measurement of income is the most important single function of accounting. While this text has emphasized the relationships of revenues and expenses to various balance sheet accounts, this section presents additional details on the auditing of operations.

The Auditors' Approach to Auditing Operations

LO 16-1

Identify the audit objectives for revenue and expense accounts.

The doctrine of **conservatism** is a powerful force influencing decisions on revenues and expenses. The concept remains important in large part due to the subjectivity involved with many accounting estimates (as for expected future credit losses on receivables, lives of assets, and the warranty liability for products sold). Conservatism in the valuation of assets means that when two (or more) reasonable alternative values are indicated, the accountant will choose the lower amount. For valuation of liabilities, the higher amount is chosen.

Therefore, when applied to the income statement, the conservatism concept results in a low or "conservative" income figure.

Most auditors have considerable respect for the doctrine of conservatism. In part, this attitude springs from the concept of legal liability to third parties. Financial statements that *understate* financial position and operating results almost never lead to legal action against the auditors involved. Nevertheless, auditors must recognize that overemphasis on conservatism in financial reporting is a narrow and shortsighted approach to meeting the needs of our society. To be of greatest value, financial statements should be neutral, rather than understate financial position and operating results. The FASB rejected conservatism as a desirable characteristic of accounting information, suggesting that it is inconsistent with neutrality.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 16-1** Identify the audit objectives for revenue and expense accounts.
- LO 16-2** Explain the relationships between revenue and expense accounts and balance sheet accounts.
- LO 16-3** Describe the nature of appropriate substantive audit procedures to accomplish the objectives for the audit of revenue and expense accounts.
- LO 16-4** Describe the fundamental controls over payroll.
- LO 16-5** Complete an audit plan for payroll.
- LO 16-6** Explain the types of procedures that are necessary to complete the audit.
- LO 16-7** Describe the auditors' responsibilities for the detection and evaluation of various types of subsequent events.
- LO 16-8** Explain the steps involved in evaluating audit findings.
- LO 16-9** Discuss the auditors' post-audit responsibilities.

Auditors obtain evidence about many income statement accounts concurrently with related balance sheet accounts. Depreciation expense, for example, is most conveniently verified along with the plant and equipment accounts. Once the existence and cost of depreciable assets are established, the verification of depreciation expense is merely an additional step. On the other hand, to verify depreciation expense without first establishing the nature and amount of assets owned and subject to depreciation would obviously be a cart-before-the-horse approach. The same line of reasoning suggests that the auditors' work on inventories, especially in determining that inventory transactions were accurately cut off at the end of the period, is a major step toward the verification of the income statement figures for sales and cost of goods sold.

The auditors' examination of operations should, however, be much more than an incidental by-product of the examination of assets and liabilities. They use a combination of cross-referencing, control testing, analytical procedures, and analysis of specific transactions to bring to light errors, omissions, and inconsistencies not disclosed in the audit of balance sheet accounts.

Specifically, the objectives for the audit of revenues and expenses are to

1. Use the understanding of the client and its environment to consider *inherent risks*, including fraud risks, related to revenues and expenses.
2. Consider *internal control* over revenues and expenses.
3. Assess the *risks of material misstatement* of revenues and expenses and design further audit procedures that
 - a. Establish the *occurrence* of recorded revenue and expense transactions.
 - b. Determine the *completeness* of recorded revenue and expense transactions.
 - c. Establish the *accuracy* of revenue and expense transactions.
 - d. Verify the *cutoff* of revenue and expense transactions.
 - e. Determine that the *presentation* and *disclosure* of revenue and expense accounts are appropriate, including the proper classification of amounts and the proper presentation of earnings-per-share data.

Internal Control over Revenues and Expenses

In Chapters 10 through 15 we discussed many controls over revenue and expense accounts, such as segregation of duties, and controls over the processing of transactions. Management also uses **management review controls** to help detect and correct misstatements that are not prevented or detected by other controls. For example, business segment controllers of a company might review the monthly schedule of revenues and expenses for their segments for unusual amounts or relationships. In performing the review, a controller may compare the amounts to prior-year or forecasted amounts and evaluate expenses as a percentage of sales. In effect, these management reviews are much like the auditors' analytical procedures in that management develops an expectation about an amount, compares the expectation to the recorded amount, and investigates significant differences.

The auditors will evaluate management review controls by considering the relevance of the assertions addressed, the level of aggregation of the data, the consistency of performance, the predictability of management expectations, and the criteria used to determine when items are investigated. If the design of controls is considered to be effective, the auditors may test the controls by inspecting documentation of performance of the controls, including the manner in which unusual items or relationships were identified, investigated, and resolved.

Revenue

LO 16-2

Explain the relationships between revenue and expense accounts and balance sheet accounts.

The auditors' review of revenue was considered in connection with accounts receivable in Chapter 11. In this section, we consider (1) the relationship of revenue to various balance sheet accounts and (2) the miscellaneous revenue account.

Relationship of Revenue to Balance Sheet Accounts

As pointed out previously, most revenue accounts are verified by the auditors in conjunction with the audit of a related asset or liability. The following list summarizes the revenue verified in this manner:

Balance Sheet Item	Revenue
Accounts receivable	Sales
Notes receivable	Interest
Securities and other investments	Interest, dividends, gains on sales, and share of investee's income
Property, plant, and equipment	Rent and gains on sale
Intangible assets	Royalties

As we discussed in Chapter 11, auditors perform various tests of controls on significant aspects of sales transactions searching for a variety of potential misstatements—Figure 11.4 illustrates this with examples of errors and fraud. The audit procedures included in that chapter include a variety of analytical and other data analytics procedures expected to identify potential misstatements of revenues, including procedures that address the possibility of improper recording of sales around year-end.

Miscellaneous Revenue

Miscellaneous revenue, by its very nature, is a mixture of minor items, some nonrecurring and others likely to be received at irregular intervals. If the client's personnel receive a cash payment and are not sure of the source, it is likely that it will be recorded as miscellaneous revenue. Because of the nature of items often recorded in the Miscellaneous Revenue account, the auditors will obtain an analysis of the account. Among the items the auditors might find improperly included as miscellaneous revenue are the following:

1. Collections on previously written-off accounts or notes receivable, which should properly be recorded as an increase in the allowance for uncollectible notes account.
2. Write-offs of old outstanding checks or unclaimed wages. In many states, unclaimed properties revert to the state after statutory periods; in such circumstances, these write-offs should be credited to a liability account rather than to miscellaneous revenue.
3. Proceeds from sales of scrap. Scrap sale proceeds generally should be applied to reduce cost of goods sold, under by-product cost accounting principles.
4. Rebates or refunds of insurance premiums. These refunds should be offset against the related expense or unexpired insurance.
5. Proceeds from sales of plant assets. These proceeds should be accounted for in the determination of the gain or loss on the assets sold.

These items may be effectively identified through the use of data analytic techniques. As an example, the auditors may identify unusual items by computer review of detailed descriptions of revenue entries, or by searching for entries with unusual combinations of debits and credits.

The auditors should propose adjusting journal entries to classify correctly any material items of the types described in the preceding list that have been included in miscellaneous revenue by the client. Before concluding the work on revenue, the auditors should perform analytical procedures and investigate unusual fluctuations. Material amounts of unrecorded revenue, as well as significant misclassifications affecting revenue accounts, may be discovered by these procedures.

Expenses

The auditors' work relating to purchases and cost of goods sold was covered in Chapter 12. We are now concerned with audit procedures for other types of expenses.

Relationship of Expenses to Balance Sheet Accounts

Let us consider for a moment the expense accounts for which we have already outlined audit procedures in the chapters dealing with balance sheet topics:

Balance Sheet Item	Expenses (and Costs)
Accounts and notes receivable	Uncollectible accounts and notes expense
Inventories	Purchases, cost of goods sold, and payroll
Property, plant, and equipment	Depreciation, repairs and maintenance, and depletion
Intangible assets	Amortization
Accrued liabilities	Commissions, fees, bonuses, product warranty expenses, and others
Interest-bearing debt	Interest

In the following sections, we will complete our review of expenses by considering additional audit objectives and procedures for selling, general, and administrative expenses other than those listed above.

Substantive Procedures for Selling, General, and Administrative Expenses

LO 16-3

Describe the nature of appropriate substantive audit procedures to accomplish the objectives for the audit of revenue and expense accounts.

To get additional evidence about the reasonableness of expense accounts, the following substantive tests are appropriate:

1. Perform analytical procedures related to the accounts.
 - a. Develop an expectation of the account balance.
 - b. Determine the amount of difference from the expectation that can be accepted without investigation.
 - c. Compare the company's account balance with the expected account balance.
 - d. Investigate significant deviations from the expected account balance.
2. Review journals and ledgers for unusual items that may be indicative of misstatements.
3. Obtain or prepare analyses of selected expense accounts.
4. Obtain or prepare analyses of critical expenses in income tax returns.

1. Perform Analytical Procedures Related to the Accounts.

a. Develop an Expectation of the Account Balance.

Auditors develop an expectation of the account balance by considering factors such as budgeted amounts, the prior-year audited balances, industry averages, relationships among financial data, and relevant nonfinancial data.

An effective budgeting program will reduce the risk of material misstatement because budgets provide management with information as to expected amounts. The existence of these expected expense amounts increases the likelihood that errors will be detected by management because any significant discrepancy between budgeted and actual amounts receives timely attention.

The existence of a good budgeting program also helps the auditors in their audit of expense accounts. When the control over budgeting has been found to be effective, the budgeted amounts often provide the auditors with very good expected amounts for their analytical procedures.

One of the previously described audit objectives was to determine whether expenses had been correctly classified. The classification of such costs may affect net income. For example, manufacturing overhead costs may properly be carried forward as part of inventory cost, whereas the expenses of selling, general, and administrative functions usually are deducted from revenue in the period incurred. The auditors' review of the propriety of classification of expenses can be linked conveniently with the comparison of amounts of the various expenses. Comparison of yearly totals is accomplished by inclusion of amounts for the preceding year on the auditors' lead schedules or working trial balance, but this procedure may be supplemented by comparison of expenses (and revenues) on a month-by-month time period basis.

Comparison of expense (as well as revenue) accounts with industry and nonfinancial data is another means of bringing to light circumstances that require investigation. The auditors also may examine relationships between financial and nonfinancial information, such as between production records stated in gallons or pounds and the dollar amounts of sales.

b. Determine the Amount of Difference from the Expectation That Can Be Accepted without Investigation.

The auditors use their estimates of materiality to arrive at which differences are to be investigated and which might be expected to occur by chance. However, the extent of the assurance desired from the analytical procedure also should be considered.

c. Compare the Company's Account Balance with the Expected Account Balance.

Comparisons of the expense accounts with expected amounts may reveal significant differences that warrant investigation.

d. Investigate Significant Deviations from the Expected Account Balance.

The starting point for investigating significant variations in expenses generally is inquiry of management. The auditors substantiate management's explanations for significant variations by various means, including analyses of accounts.

2. Review Journals and Ledgers for Unusual Items That May Be Indicative of Misstatements.

Reviewing journals and ledgers for unusual entries, amounts, and other items is an effective way of obtaining additional evidence about expense accounts. The auditors will look for items such as unusually large entries, entries from unusual sources, and entries with unusual timing. Data analytics software can make this review process more efficient, as the software can review all of the entries for a period based on the auditors' predefined criteria. Also, the data analytics applied to cash disbursements as described in Chapter 10 would be expected to identify potential misstatements of expenses.

3. Obtain or Prepare Analyses of Selected Expense Accounts.

As a result of the above procedure, the auditors will have chosen certain expense accounts for further verification. The client should be requested to furnish analyses of the accounts selected, together with related vouchers and other supporting documents, for the auditors' review.

Although the circumstances of the engagement determine the most important expense accounts, the following are frequently among those considered in detail: (a) advertising, (b) research and development, (c) legal expenses and other professional fees, (d) maintenance and repairs, and (e) rents and royalties.

The analyses of legal and other professional fees may disclose legal and audit fees properly chargeable to costs of issuing stock or debt instruments, or to costs of business combinations. Also, the analysis of professional fees expense furnishes the names of attorneys to whom letters should be sent requesting information as to pending litigation and other loss contingencies. Figure 16.1 illustrates an analysis of the professional fees expense account.

4. Obtain or Prepare Analyses of Critical Expenses in Income Tax Returns.

Income tax returns generally require schedules for officers' salaries, directors' fees, taxes, travel and entertainment, contributions, and casualty losses. In addition to these, officers' expense account allowances are presented in the analysis of officers' salaries. Accordingly, the auditors should obtain or prepare analyses of any of these expenses that were not analyzed when performing other audit steps. The auditors should bear in mind that details of these expenses will probably be closely scrutinized when the state or federal revenue agents examine the client's tax returns.

FIGURE 16.1 Professional Fees Analysis

CHEVIOT CORPORATION Professional Fees Expense Year Ended December 31, 20X3					R-3-7
Acct. No. 547	Date	Reference	Payee	Description	Amount
	Various	Various	Hale and Hale	Monthly retainer for legal services—12 x \$1,000	\$12,000
	Mar. 5, X3	CD 411	Jay & Wall, CPAs	Fee for the audit	22,000 ✓
	May 2, X3	CD 602	Hale and Hale	Fee for legal services relating to acquisition of real property adjoining Vancouver plant	6,000 ✓
	Sept. 18, X3	DC 1018	Hale and Hale	Fee for legal services relating to modification of installment sales contract forms	800 ✓
	Dec. 31, X3			Balance per Ledger	<u>\$40,800</u>
	Dec. 31, X3	AJE 41	To capitalize May 2, X3, disbursement as part of cost of land K-1		<u>6,000</u>
	Dec. 31, X3	Adjusted balance			<u>\$34,800</u> ^
		AJE 41			to R-3
		Land		6,000	
		Professional Fees		6,000	
		To capitalize legal fees for acquiring land			

^ Footed and agreed to general ledger balance.
 ✓ Examined billing and copy of client's check in payment thereof.

Conclusion:

Professional fees expense is fairly presented in the adjusted amount of \$34,800.

KGL
2/15/X4
 CMM
2/20/X4

The Audit of Payroll



The payroll in many companies is the largest operating cost and therefore deserves the close attention of management as well as the auditors. In the past, payroll frauds were common and often substantial. Today, however, such frauds may be more difficult to conceal for several reasons: (1) extensive segregation of duties relating to payroll; (2) the use of computers, with proper controls, for preparation of payrolls; and (3) the necessity of filing frequent reports to the government listing employees' earnings and tax withholdings.

Internal Control over Payroll

LO 16-4

Describe the fundamental controls over payroll.

The establishment of strong internal control over payroll remains important for several reasons. Although payroll frauds are less frequent today, the possibility of large-scale payroll fraud still exists. Such frauds may involve listing fictitious persons ("ghost employees") on the payroll, overpaying employees, and continuing employees on the payroll after their separation from the company. A second reason for emphasizing internal control over payroll is that a great mass of detailed information concerning hours

worked and rates of pay must be processed quickly and accurately if workers are to be paid promptly and without error. Good employee relations demand that direct deposits to employee bank accounts or paychecks be processed on time and be free from error. As pointed out in previous chapters, internal control is a means of securing accuracy and dependability in accounting data as well as a means of preventing fraud.

Still another reason for emphasizing the importance of internal control over payroll is the existence of various payroll tax and income tax laws that require that certain payroll records be maintained and that payroll data be reported to the employee and to governmental agencies. Complete and accurate records of time worked are also necessary if a company is to protect itself against lawsuits under the Fair Labor Standards Act.

To control payroll costs means to avoid waste and to obtain efficient production from the dollars expended for services of employees. As a means of establishing control over payroll costs, many companies delegate to department heads and other supervisors responsibility for the control of costs in their respective units of the business. Budgets are prepared using estimates of departmental labor costs for the coming period. As the year progresses and actual labor costs are compiled, the controller submits monthly reports to top management comparing the budgeted labor costs and the actual labor costs for each department. The effectiveness of this control procedure will depend largely upon the extent to which management utilizes these reports and takes action upon variances from the budget. These and other management reports help to assure that misstatements not detected by other controls are detected and corrected.

Most important of all controls over payroll is the division of payroll work among several departments of the company. Payroll activities include the functions of (1) employment (human resources), (2) timekeeping, (3) payroll preparation and record-keeping, and (4) distribution of pay to employees. For effective internal control, a separate department of the company should handle each of these functions. These several phases of payroll activities will now be considered individually.

Employment (Human Resources)

The first significant step in establishing strong internal control over payroll should be taken by the human resources department when a new employee is hired. At this point, the authorized rate of pay should be entered on a pay-rate record. The employee also should sign a payroll deduction authorization specifying any amounts to be withheld and a withholding tax exemption certificate. These records should be kept in the human resources department, but a notice of the hiring of the new employee, the rate of pay, and the payroll deductions should be sent to the payroll department. When a computer is used, this information will be keyed into an employee payroll master file. The human resources department, the payroll department, or data processing will enter the data into the computer system.

Under no circumstances should a name be added to the payroll without having received the formal authorization notice from the human resources department. When an employee's rate of pay is changed, the new rate should be entered on the pay-rate record (often computerized) that is maintained in the human resources department. An authorization for the new rate should be sent to the payroll department before the change can be made effective on the payroll. Upon termination of an employee, notice of termination should be sent from the human resources department to the payroll department. The work of the payroll department and the propriety of names and pay raises used in preparing the payroll, therefore, rest upon formal documents or computer input originating outside the payroll department.

Adequate internal control demands that the addition and removal of names from the company payroll, as well as rate changes and reclassification of employees, be evidenced by written approval of an executive in the human resources department and by the head of the operating department concerned. To permit the payroll department to initiate changes in pay rates or to add names to the payroll without formal authorization from the human resources department increases the opportunity for fraud.

Timekeeping

The function of timekeeping consists of determining the number of hours (or units of production) for which each employee is to be paid. The use of electronic time-recording equipment is of considerable aid in establishing adequate internal control over the timekeeping function. In addition, supervisors should maintain contact with subordinates and prepare time reports summarizing the use of labor.

Internal control can be improved by the practice of regular comparison of the time reports prepared by timekeepers or supervisors with time clock records showing the arrival and departure times of employees. If pay is based on piecework, a comparison may be made between the reports of units produced and the quantities that are added to the perpetual inventory records.

Salaried employees receiving a fixed monthly or weekly salary may not be required to use time clocks. Some companies require salaried employees to fill out a weekly or semi-monthly report indicating the time devoted to various activities. If a salaried employee is absent, the department head usually has authority to decide whether a pay reduction should be made.

Payroll Preparation and Record-Keeping

In a manual or simple computerized system, the payroll department has the responsibility for computing the amounts to be paid to employees and for preparing all payroll records. It is important that the payroll department *not* perform the related functions of timekeeping, employment, or distribution of pay to employees. The output of the payroll department may be thought of as (1) the payroll checks or direct deposits (or pay envelopes, if wages are paid in cash); (2) individual employee statements of earnings and deductions; (3) a payroll journal; (4) an employees ledger, summarizing earnings and deductions for each employee; (5) a payroll distribution schedule, showing the allocation of payroll costs to direct labor, overhead, and various departmental expense accounts; and (6) quarterly and annual reports to the government showing employees' earnings and taxes withheld. In a computerized system, many of these functions may be delegated to data processing.

In a computerized system, the payroll is calculated by the computer, using the work hours reported by the timekeeping department and the authorized pay rates and payroll deductions reported by the human resources department. In addition to preparing the payroll journal, the payroll department prepares the payroll checks or the pay envelopes, if wages are paid in cash. Checks are then forwarded to the treasurer for signature.

Regardless of the system used, the auditors should expect the client's system to include such basic records as time records, payroll journals, labor distributions, and employee earnings records. In a computerized system, some or all of these documents may exist only in computer-readable form.

Distributing Pay: Direct Deposit, Paychecks, or Cash

The distribution of pay through direct deposit, paychecks, or pay envelopes (with cash enclosed) should be performed by an individual who performs no other payroll activity. If pay is deposited directly into employee bank accounts, controls over that process are necessary, such as authorization of deposits by personnel in the treasurer's department. If pay is distributed as paychecks or pay envelopes, the task should be that of the paymaster.

Most companies that pay employees by check or direct deposit use an imprest payroll bank account. A voucher for the entire amount of the weekly payroll may be prepared in the general accounting department based on the payroll summary prepared in the payroll department. This voucher is sent to the treasurer, who issues a check on the general bank account for the amount of the payroll. The check is deposited in the imprest payroll bank account and checks or direct deposits to individual employees are drawn on the account. It also is the practice of some companies to require dual signatures on large checks and to have printed on the check a statement that this type of check is not valid if issued for an amount in excess of a specified dollar amount.

If employees are paid in cash, the paymaster will use a copy of the payroll journal and the information on the payroll envelopes (both prepared by the payroll department) to

fill the payroll envelopes with cash. The paymaster will require proof of identity when distributing checks or cash to employees and require them to sign a receipt for any cash received. All checks or pay envelopes for an absent employee should be retained and neither returned to the payroll department nor turned over to another employee for delivery.

When wages are paid in cash, any unclaimed wages should be deposited in the bank and credited to a special liability account. Subsequent disbursement of these funds to employees then will be controlled by the necessity of drawing a check and preparing supporting documents. The danger of potential defalcations in permitting unclaimed pay envelopes to be retained by the paymaster, returned to the payroll clerk, or intermingled with petty cash are apparent.

Outsourcing the Payroll Function

Recall that in Chapter 7 we used payroll as an example of an area that can be outsourced to a service organization. Because of the complex requirements relating to payroll (e.g., withholding employee taxes, making health and pension plan contributions, issuing W-2 forms, filing other required government forms), many companies find that payroll outsourcing may be particularly cost beneficial, including smaller companies that often do not have such expertise.

The advantages of such outsourcing do not come without potential risks. Varying levels of expertise and internal control at these payroll service providers may generate any number of difficulties and delays. Also, moving processing to an outsourcer presents the company with the risk that the provider might go out of business; a payroll service provider's failure to continue in operation (e.g., through corporate failure) may lead a company, at least temporarily, to lose control of its payroll data.

Major payroll service providers (e.g., ADP, Paychex, Intuit) ordinarily have the expertise to effectively provide this service. As we discussed in Chapter 7, these service providers often engage their CPAs to perform various System and Organization Controls (SOC) examinations to provide assurance relating to their system's controls. SOC reports are also discussed briefly below and in further detail in Chapter 20.

Documentation of Internal Control for Payroll

Typical of the questions to be posed by the auditors prior to the completion of an internal control questionnaire, a systems flowchart, or other record of payroll controls are the following: Are employees paid by check or direct deposit? Is a payroll bank account maintained on an imprest basis? Are the activities of timekeeping, payroll compilation, payroll check signing, and paycheck distribution performed by separate departments or employees? Are all operations involved in the preparation of payrolls subjected to independent verification before the paychecks are distributed? Are employee time reports approved by supervisors? Is the payroll bank account reconciled monthly by an employee having no other payroll duties?

Audit Plan for Payroll

LO 16-5

Complete an audit plan for payroll.

After obtaining an understanding of the client and its environment, including internal control, the auditors will assess the risks of material misstatement and design further audit procedures, including

1. Perform tests of controls over payroll transactions for selected pay periods. Examples of tests the auditors may decide to perform include
 - a. Compare names and wage or salary rates to records maintained by the human resources department.
 - b. Compare time shown on payroll to time cards and time reports approved by supervisors.
 - c. If payroll is based on piecework rates rather than hourly rates, reconcile earnings with production records.
 - d. Determine basis of deductions from payroll and compare with records of deductions authorized by employees.
 - e. Test extensions and footings of payroll.
 - f. Compare total of payroll with total of payroll checks and direct deposits issued.
 - g. Compare total of payroll with total of labor cost summary prepared by cost accounting department.
 - h. If wages are paid in cash, compare receipts obtained from employees with payroll records.

- i. If wages are paid by check, compare checks (ordinarily electronic copies) with payroll and with payroll records.
 - j. If wages are paid by direct deposit, compare listing of employee payments with payroll and direct deposit authorizations.
 - k. Observe the use of time clocks by employees reporting for work and investigate timecards not used.
2. Perform analytical procedures or data analytics to test payroll expense. As an example, the auditors may perform the analytical procedure of developing an expectation about the amount of payroll expense by multiplying the amount of one pay period by the number of pay periods in the year and comparing that to the total amount recorded. Data analytics may be used to simultaneously test controls over payroll and perform substantive tests.
 3. Investigate any extraordinary fluctuations in salaries, wages, and commissions.
 4. Obtain or prepare a summary of compensation of officers for the year and compare to contracts, minutes of directors' meetings, or other authorization.
 5. Test the period-end accrual of payroll expense.
 6. Test computations of compensation earned under profit-sharing or bonus plans.
 7. Test commission earnings by examination of contracts and detailed supporting records.
 8. Test pension obligations by reference to authorized pension plans and supporting records.

Figure 16.2 relates these procedures to their primary audit objectives.

When a client uses a payroll service provider, that provider's controls become relevant to the audit. In essence, if controls are to be relied upon, the operating effectiveness of controls at both the service provider and audit client are relevant. Auditors obtain evidence relating to the service provider's controls either through performing tests of control procedures directly upon the service provider's controls or by considering a service auditor's report on controls. An overview of auditor responsibilities when relying on a service auditors' report is presented in Chapter 7 and Chapter 20.

The tests of controls included in the audit plan may be performed individually using the appropriate underlying files. For example, actual salary rates paid may be compared to authorized amounts in human resources employee files; likewise, records of time worked may be compared to payroll records. While these procedures might be performed manually, a more sophisticated data analytics approach might involve performing tests on 100 percent of the transactions. To perform these tests, appropriate databases may be joined or related with one another. As examples, the auditors may

1. Identify duplicate payroll checks (also, direct deposits or cash payments) to employees within pay periods.
2. Identify multiple payments to the same bank account within pay periods, with both the same and different employee names.

FIGURE 16.2
Objectives of Major
Substantive Procedures
for Payroll

Substantive Procedures	Primary Audit Objectives
Perform analytical procedures or data analytics. Investigate fluctuations in salaries, wages, and commissions. Obtain a summary of amounts of officers' compensation and trace to authorization.	<i>Existence and occurrence</i> <i>Completeness</i> <i>Accuracy</i>
Test the period-end accrual of payroll expenses.	<i>Existence and occurrence</i> <i>Completeness</i> <i>Accuracy</i> <i>Cutoff</i>
Test computations of compensation under profit-sharing or bonus plans. Test commission earnings. Test pension obligations.	<i>Accuracy</i>

3. Identify pay deposited to the same bank account of that of a vendor in the vendor master file.
4. Identify false, invalid, or duplicate Social Security numbers.
5. Identify differences in pay between union agreements and actual payments.
6. Compare and summarize costs for special pay, overtime, and premiums.

For clients that distribute checks or cash payments and have significant payroll control weaknesses, auditors have historically performed a surprise observation of a regular distribution of paychecks to employees. Although this procedure is less frequent today, due in part to direct deposit of wages, the auditors' objective in observing the distribution of checks or cash to employees on a regular payday is to determine that every name on the company payroll is that of a bona fide employee presently on the job. This audit procedure is especially desirable if the various phases of payroll work are not sufficiently segregated by departments to afford good internal control. The history of payroll frauds shows that permitting one person to have custody of employment records, time cards, paychecks, and employees' earnings records often has led to the entering of fictitious names on the payroll and to other forms of fraud, such as use of excessive pay rates and continuance of pay after the termination of an employee. When performing this procedure, the auditors first will determine that they have possession of all the checks or envelopes comprising the payroll. They will then accompany representatives of the client around the plant as all the checks or envelopes are distributed to employees. It is essential that the auditors establish the identity of each employee receiving payment.

Audit of the Statement of Cash Flows

The statement of cash flows is prepared from other financial statements and from analyses of increases and decreases in selected account balances. The amounts included in the statement of cash flows are audited in conjunction with the audit of balance sheet and income statement accounts. Thus, limited substantive procedures are necessary. The auditors merely compare the amounts included in the statement of cash flows to other financial statement balances and amounts included in audit working papers.

Because receipts and payments must be classified in the statement of cash flows as to whether they are from operating, investing, or financing activities, the presentation and disclosure audit objective is especially important. The auditors should determine that the amount of cash, or cash and cash equivalents, analyzed in the statement agrees with an amount shown on the balance sheet. Finally, the auditors should ascertain that a statement of cash flows is presented for each year for which an income statement is presented.

Completing the Audit

LO 16-6

Explain the types of procedures that are necessary to complete the audit.

The auditors' report should not be dated prior to the date they have gathered sufficient, appropriate evidence. This date is often the last day of fieldwork, but it may be a later date. Therefore, the auditors' opinion on the financial statements is based on all evidence gathered by the auditors up to the date of the audit report and any other information that comes to their attention between that date and the issuance of the financial statements. To be effective, certain audit procedures described in previous chapters cannot be completed before the end of the audit. Among those procedures are the following:

1. Search for unrecorded liabilities.
2. Review the minutes of meetings.
3. Perform final analytical procedures.
4. Perform procedures to identify loss contingencies.
5. Perform the review for subsequent events.
6. Obtain the representation letter.
7. Communicate misstatements to management.
8. Evaluate audit findings.

Search for Unrecorded Liabilities

As discussed in Chapter 14, auditors should be alert for **misstatements** due to unrecorded payables. The search for unrecorded liabilities includes procedures performed near the date of the auditors' report, such as examining subsequent cash disbursements. These procedures are designed to detect liabilities that existed at year-end but were omitted from the liabilities recorded in the client's financial statements.

Review the Minutes of Meetings

The auditors should review the **minutes** of meetings of stockholders and directors, including important subcommittees of directors such as the audit committee and the investment committee. This review includes meetings held through the date of the audit report. In completing the audit, the auditors should determine that they have considered all minutes, including those for meetings subsequent to year-end. They also will obtain written representation from management that all minutes have been made available.

Perform Final Analytical Procedures

The discussion of **analytical procedures** in Chapter 5 pointed out that they should be performed as a part of the auditors' risk assessment as well as near the end of the audit. Those performed near the end of the audit assist the auditors in assessing the validity of the conclusions reached, including the opinion to be issued. This final review may identify areas that need to be examined further as well as provide a consideration of the adequacy of data gathered in response to unusual or unexpected relationships identified during the audit. The professional standards (AICPA AU-C 240; PCAOB AS 2401) specifically require auditors to evaluate whether analytical procedures performed as substantive procedures or in the overall review stage indicate a previously unrecognized risk of material misstatement due to fraud.

Perform Procedures to Identify Loss Contingencies

A **loss contingency** may be defined as a *possible* loss, stemming from past events that will be resolved as to existence and amount by some future event. Central to the concept of a contingent loss is the idea of uncertainty—uncertainty as to both the amount of loss and whether, in fact, any loss has been incurred. This uncertainty is resolved when some future event occurs or fails to occur.

Most loss contingencies may also appropriately be called **contingent liabilities**. *Loss contingencies*, however, is a broader term, encompassing the possible impairment of assets as well as the possible existence of liabilities. The audit problems with respect to loss contingencies are twofold. First, the auditors should determine the existence of the loss contingencies. Because of the uncertainty factor, most loss contingencies do not appear in the accounting records, and a systematic search is required if the auditors are to have reasonable assurance that no important loss contingencies have been overlooked. Second, the auditors should appraise the probability that a loss has been incurred and its amount. This is made difficult both by the uncertainty factor and also by the tendency of the client management to maintain at least an outward appearance of optimism.

In FASB ASC 450-20, "Loss Contingencies," the Financial Accounting Standards Board set forth the criteria for accounting for loss contingencies. Such losses should be reflected in the accounting records when both of the following conditions are met: (1) Information available prior to the issuance of the financial statements indicates that it is *probable* that a loss has been sustained before the balance sheet date and (2) the amount of the loss can be *reasonably estimated*. Recognition of the loss may involve either recognition of a liability or reduction of an asset. When a loss contingency has been accrued in the accounts, it is usually desirable to explain the nature of the contingency in a note to the financial statements and to disclose any exposure to loss in excess of the amount accrued.

Loss contingencies that do not meet both of the above criteria should still be disclosed in a note to the financial statements when there is at least a *reasonable possibility* that a loss has been incurred. This disclosure should describe the nature of the contingency and, if possible, provide an estimate of the possible loss. If the amount of possible loss cannot

be reasonably estimated, the disclosure should include either a range of loss or a statement that an estimate cannot be made.

Certain contingent liabilities traditionally have been disclosed in financial statement notes even though the possibility that a loss has occurred is remote. Such items include notes receivable discounted and guarantee endorsements. With the exception of those items for which disclosure is traditional, disclosure need not be made of loss contingencies when the possibility of loss is remote.

The procedures undertaken by auditors to identify the existence of loss contingencies and to assess the probability of loss vary with the nature of the contingent item. Regardless of the procedures performed, it is important that they be extended to near the date of the auditors' report so that the auditors have the latest available information to evaluate the financial statement presentation and disclosure of loss contingencies. To illustrate these types of procedures, we will discuss several of the more frequent types of contingencies warranting financial statement disclosure.

Litigation

Perhaps the most common loss contingency appearing in the financial statements is that stemming from actual or potential litigation. AICPA AU-C 501 and PCAOB AS 2505 provide guidance in this area and require that auditors design and perform audit procedures to identify litigation, claims, and assessments that may give rise to a risk of material misstatement, including

- Inquiring about these matters with management and others in the organization, including in-house legal counsel.
- Obtaining from management a description and evaluation of litigation, claims, and assessments, including identification of those matters referred to legal counsel.
- Reviewing (1) minutes of meetings of those charged with governance; (2) documents in management's possession regarding litigation, claims, and assessments; and (3) correspondence with legal counsel.
- Reviewing legal expense accounts and invoices from legal counsel.

When actual or potential litigation is identified, the auditors obtain evidence relevant to identifying the cause, degree of probability of an unfavorable outcome, and the amount of potential loss.

Unless the above audit procedures indicate no actual or potential litigation, claims, or assessments, the auditors should directly communicate with the client's external legal counsel through a **letter of inquiry** prepared by management and sent by the auditors. The letter should ask legal counsel to reply as of a date approximating the estimated date of the audit report to allow the auditors to receive the most current information possible. The letter of inquiry may be limited to material items providing that the auditors and management have reached an agreement as to what is material.

The letter of inquiry asks legal counsel to corroborate the information provided by management and to comment on those areas where their views differ from those of management. Legal counsel is also requested to identify any pending claims, litigation, or assessments that have been omitted from management's list. The letter from the external legal counsel may be limited to those matters to which the attorney has given substantive attention in the form of consultation or representation. If in-house legal counsel has primary responsibility for any particular litigation, claim, or assessment, similar information should be requested of them, although this is not a substitute for seeking the information from external counsel.

The letter of inquiry also should include a list of certain **unasserted claims** on which individuals or organizations have not yet taken legal action against the company. An unasserted claim should be on the list if the legal counsel has devoted substantive attention to it and if it is (1) *probable* that a claim will be asserted and (2) *reasonably possible* that a loss will result. The letter of inquiry should request that the legal counsel comment on those matters on which its views concerning the description or evaluation of the

matter differ from those stated by management. However, if management fails to list an unasserted claim, legal counsel is *not* required to describe the claim in the reply to the auditors; the lawyer is, however, generally required to inform the client of the omission and to consider resignation if the client fails to inform the auditors about the claim. For this reason, auditors should always consider carefully the reasons for any legal counsel's resignation.

What should the auditors do if the client's legal counsel refuses to respond appropriately to the letter of inquiry or management refuses to provide the auditors with permission to communicate with legal counsel? In these situations, the auditors should attempt to obtain evidence by performing alternative procedures. If the auditors are unable to obtain sufficient appropriate audit evidence by performing alternative audit procedures, they should modify their opinion due to the lack of sufficient appropriate audit evidence, as discussed in Chapter 17.

Illustration of Disclosure

The following note to the financial statements of an aircraft manufacturer illustrates the disclosure of the contingent liability associated with pending litigation.

A number of suits are pending against the Company as the result of accidents in prior years involving airplanes manufactured by the Company. It is believed that insurance carried by the Company is sufficient to protect it against loss by reason of suits involving the lives of passengers and damage to aircraft. Other litigation pending against the Company involves no substantial amount or is covered by insurance.

The note of another large corporation contained the following concerning contingent liabilities:

The Company is a party to a number of lawsuits and claims (some of which are for substantial amounts) arising out of the conduct of its business, including those relating to commercial transactions, product liability, and environmental, safety, and health matters. While the ultimate results of lawsuits or other proceedings against the Company cannot be predicted with certainty, management does not expect that these matters will have a material adverse effect on the consolidated financial position or results of operations of the Company.

Income Tax Disputes

The necessity of estimating the income tax liability applicable to the year under audit was discussed in Chapter 14. In addition to the taxes relating to the current year's income, uncertainty often exists concerning the amount ultimately payable for prior years. A lag of two or three years often exists between the filing of income tax returns and the final settlement after review by the Internal Revenue Service (IRS). Disputes between the taxpayer and the IRS may create contingent liabilities not settled for several more years. The auditors should determine whether internal revenue agents have examined any returns of the client since the preceding audit and, if so, whether any additional taxes have been assessed. In addition, the auditors should review any correspondence with the IRS and any other regulatory agencies.

Accommodation Endorsements and Other Guarantees of Indebtedness

The endorsement of notes of other concerns or individuals is very seldom recorded in the accounts, but may be reflected in the minutes of directors' meetings. The practice is more common among small concerns—particularly when one person has a proprietary interest in several companies. Officers, partners, and sole proprietors of small organizations should be questioned as to the existence of any contingent liability from this source. Inquiry also should be made as to whether any collateral has been received to protect the

company. The auditors also may decide to confirm written or oral guarantees or other contingent liabilities with appropriate financial institutions, using a specially designed confirmation letter.

Accounts Receivable Sold or Assigned with Recourse

When accounts receivable are sold or assigned *with recourse*, a guarantee of collectibility is given. Authorization of such a transaction should be revealed during the auditors' reading of the minutes, and evidence of such agreements also may be found during the examination of transactions and correspondence with financial institutions. Confirmation by direct communication with the purchaser or assignee is necessary for any receivables sold or assigned.

Environmental Issues

Environmental remediation liability laws, written at all levels of government, are increasingly leading to both contingent and accrued liabilities. The Resource, Conservation, and Recovery Act; Superfund; and various clean air and water acts create potential liability for companies, as illustrated in the following example focusing on the electronics industry.

Focus on the Electronics Industry

The electronics industry and other high-technology enterprises may find themselves liable for remediation of environmental contamination. As described in an AICPA industry *Audit Risk Alert*, Superfund legally empowers the U.S. Environmental Protection Agency to seek recovery from both current and previous owners or operators of a contaminated site or anyone who generated or transported hazardous substances to or from such a site. The use of toxic or hazardous materials in the electronics industry or the manufacturing of by-products that adversely affect the environment may create environmental cleanup issues. Various professional pronouncements released interpret accounting requirements for environmental matters to help companies determine when it is appropriate to disclose or possibly accrue liabilities for such matters.

Commitments

Closely related to contingent liabilities are obligations termed **commitments**. The auditors may discover during their audit any of the following commitments: inventory purchase commitments, commitments to sell merchandise at specified prices, contracts for the construction of plant and equipment, pension or profit-sharing plans, long-term operating leases of plant and equipment, employee stock option plans, and employment contracts with key officers. A common characteristic of these commitments is the contractual obligation to enter into transactions *in the future*.

To illustrate the relationship of a commitment to a loss contingency, assume that a manufacturer commits to sell a substantial part of its output at a fixed price over the next three years. At the time of forming the agreement, the manufacturer, of course, believes the arrangement to be advantageous. However, it is possible that rising price levels may transform the fixed-price sales agreement into an unprofitable one, requiring sales to be made at prices below manufacturing cost. Such circumstances may warrant recognition of a loss in the financial statements.

All classes of material commitments may be described in a single note to financial statements, or they may be included in a "Contingencies and Commitments" note.

General Risk Contingencies

In addition to loss contingencies and commitments, all businesses face the risk of loss from numerous factors called **general risk contingencies**. A general risk contingency represents a loss that *might occur in the future*, as opposed to a loss contingency that *might have occurred in the past*. Examples of general risk contingencies are threat of a strike or consumer boycott, risk of price increases in essential raw materials, and risk of a natural catastrophe.

Because the events that might produce a loss actually have not occurred and they are part of the general business environment, general risk contingencies ordinarily *need not be disclosed* in financial statements. The lack of insurance coverage is a general risk contingency. Neither the adequacy nor the lack of insurance coverage is required to be presented in financial statements.

The Auditors' Procedures for Loss Contingencies

An overview of the auditors' procedures to detect and evaluate loss contingencies is described below.

1. Review the minutes of directors' meetings to the date of completion of fieldwork. Important contracts, lawsuits, and dealings with subsidiaries are typical of matters discussed in board meetings that may involve loss contingencies.
2. Send a letter of inquiry to the client's lawyer requesting
 - a. A description (or evaluation of management's description) of the nature of pending and threatened litigation and tax disputes.
 - b. An evaluation of the likelihood of an unfavorable outcome in the matters described.
 - c. An estimate of the probable loss or range of loss, or a statement that an estimate cannot be made.
 - d. An evaluation of management's description of any unasserted claims that, if asserted, have a reasonable possibility of an adverse outcome.
 - e. A statement of the amount of any unbilled legal fees.
3. Send confirmation letters to financial institutions to request information on contingent liabilities of the company.
4. Review correspondence with financial institutions for evidence of accommodation endorsements, guarantees of indebtedness, or sales or assignments of accounts receivable.
5. Review reports and correspondence from regulatory agencies to identify potential assessments or fines.
6. Obtain a representation letter from the client indicating that all liabilities known to officers are recorded or disclosed.

Perform the Review for Subsequent Events

LO 16-7

Describe the auditors' responsibilities for the detection and evaluation of various types of subsequent events.

Evidence not available at the close of the period under audit often becomes available before the auditors finish their fieldwork and issue their audit report. The CPA's opinion on the fairness of the financial statements may be changed considerably by these subsequent events. The term **subsequent event** refers to an event occurring after the date of the balance sheet but prior to the date of the auditors' report (the date on which the auditors have obtained sufficient appropriate audit evidence to support their opinion). FASB ASC 855 divides subsequent events into two broad categories: (1) those providing additional evidence about facts existing on or before the balance sheet date ("recognized subsequent events") and (2) those involving facts coming into existence subsequent to the balance sheet date ("nonrecognized subsequent events").

Type 1 Subsequent Events

The first type of subsequent event provides additional evidence as to *conditions that existed at the date of the financial statements*. This type of subsequent event requires that the financial statement amounts be adjusted to reflect the changes in estimates resulting from the additional evidence.

As an example, let us assume that a client's accounts receivable at December 31 included one large account and numerous small ones. While management regarded the large account's balance as fully collectible at year-end, during the course of the audit the customer entered bankruptcy. The auditors' procedures revealed that, although the bankruptcy occurred early in January, the financial strength of the customer had deteriorated before December 31, and the client was simply in error in believing the receivable to be fully collectible at that date. Accordingly, the auditors recommended an increase

in the December 31 allowance for uncollectible accounts. Evidence becoming available after the balance sheet date through the date of issuance of the auditors' report should be used in making judgments about the valuation of receivables.

Other examples of this first type of subsequent event include the following:

1. Customers' checks included in the cash receipts of the last day of the year prove to be uncollectible and are charged back to the client's account by the bank. If the checks were material in amount, an adjustment of the December 31 cash balance may be necessary to exclude the checks now known to be uncollectible.
2. A new three-year union contract signed two weeks after the balance sheet date provides evidence that the client has materially underestimated the total cost to complete a long-term construction project on which revenue is recognized by the percentage-of-completion method. The amount of income (or loss) to be recognized on the project in the current year should be recomputed using revised cost estimates.
3. Litigation pending against the client is settled shortly after the balance sheet date, and the amount owed by the client is material. This litigation was to be disclosed in notes to the financial statements, but no liability had been accrued because at year-end no reasonable estimate could be made as to the amount of the client's loss. Now that appropriate evidence exists as to the dollar amount of the loss, this loss contingency meets the criteria for accrual in the financial statements, rather than mere note disclosure.

Type 2 Subsequent Events

The second type of subsequent event involves conditions *that arose after the date of the financial statements*. These events do not require adjustment to the dollar amounts shown in the financial statements, *but they should be disclosed in the financial statement notes if the statements otherwise would be misleading*. To illustrate, assume that shortly after the balance sheet date a client sustains an uninsured fire loss destroying most of its plant assets. The carrying value of plant assets should not be reduced in the balance sheet because these assets were intact at year-end. However, people analyzing the financial statements would be misled if they were not advised that most of the plant assets are no longer in a usable condition.

Other examples of nonrecognized subsequent events occurring after the balance sheet date but before the release of the financial statements include

- Sale of a bond or capital stock.
- A business combination with another company.
- Settlement of litigation when the event giving rise to the claim took place after the balance sheet date.
- Loss of plant or inventories due to a fire.
- Losses on receivables resulting from conditions (e.g., a customer's major casualty) arising after the balance sheet date.
- Changes in the fair value of assets or liabilities or foreign exchange rate.

If the financial statements would be misleading without such disclosure, any such subsequent event should be reported in the financial statement notes with an estimate of the financial effect, or a statement that such an estimate cannot be made. Auditors may choose to add an **emphasis-of-matter** section (paragraph) to their audit report referring to the subsequent event and its description in the financial statements. Other subsequent events that relate less directly to accounting matters are less likely to be disclosed in the financial statements (e.g., an employee strike, introduction of a new line of products, or death of an executive).

Pro Forma Statements as a Means of Disclosure

Occasionally, subsequent events may be so material that supplementary *pro forma financial statements* should be prepared giving effect to the events as if they had occurred as

of the balance sheet date. The pro forma statements (usually a balance sheet only) may be presented in columnar form next to the audited financial statements. This form of disclosure is used only when the subsequent event has a significant effect upon the asset structure or capital structure of the business. An example would be a business combination.

Distinguishing between the Two Types of Subsequent Events

In deciding whether a particular subsequent event should result in an adjustment to the financial statements or a note disclosure, the auditor should carefully consider *when the underlying conditions came into existence*. For example, assume that shortly after the balance sheet date, a major customer of the audit client declares bankruptcy, with the result that a large receivable previously considered fully collectible now appears to be uncollectible. If the customer's bankruptcy resulted from a steady deterioration in financial position, the subsequent event provides evidence that the receivable actually was uncollectible at year-end, and the allowance for doubtful accounts should be increased. On the other hand, if the customer's bankruptcy stemmed from a casualty (such as a fire) occurring after year-end, the conditions making the receivable uncollectible came into existence after the balance sheet date. In this case, the subsequent event should be disclosed in a note to the financial statements.

The 2020 pandemic caused by the COVID-19 virus also raises issues related to when the underlying conditions came into existence. This is particularly relevant to the large number of companies whose fiscal year ends on December 31. Some accountants have suggested that since the risk was initially identified in China in November of 2019, it can be viewed as a Type 1 subsequent event. However, most have viewed it as a Type 2 subsequent event in that (1) the earliest reported cases in the United States appear to have occurred in mid-January 2020, (2) the World Health Organization did not declare it a global public health emergency until the end of January, and (3) no U.S. government actions were taken until 2020.

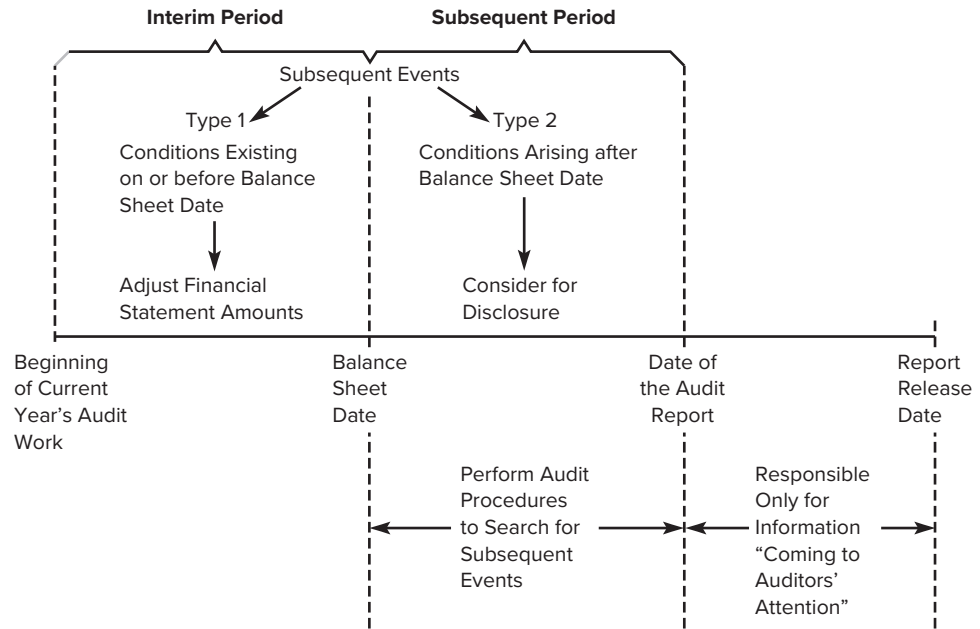
Audit Procedures Relating to Subsequent Events

For the period after year-end through the date of the auditors' report, the auditors should perform audit procedures to obtain sufficient appropriate audit evidence that all subsequent events that require adjustment or disclosures in the financial statements have been identified. During this period, the auditors should determine that proper cutoffs of cash receipts and disbursements and sales and purchases have been made, and they should examine data to aid in the evaluation of assets and liabilities as of the balance sheet date. In addition, the auditors should

1. Obtain an understanding of management's procedures to ensure that subsequent events are identified.
2. Inquire of management (and those charged with governance) about whether subsequent events have occurred.
3. Read available minutes of directors, stockholders, and appropriate committee meetings that have been held after the date of the financial statements and inquire about matters discussed at any such meeting for which minutes are not yet available.
4. Read the company's latest subsequent interim financial statements, if any.

Generally, the auditors' responsibility for performing procedures to gather evidence as to subsequent events extends only through the date of the audit report. However, even after completing normal audit procedures, the auditors are responsible for evaluating subsequent events that come to their attention prior to the report release date. Suppose, for example, that the auditors completed their work for a December 31 audit on February 3 and thereafter began drafting their report. On February 5, before issuing their report, the client informed the auditors that the client had settled a lawsuit on that day by a substantial payment. In such a circumstance, generally accepted accounting principles require that the liability be established in the December 31 balance sheet. If the adjustment does not also require a note disclosure, the audit report ordinarily continues to be dated as of the date the auditor had sufficient audit evidence, February 3. If a related note disclosure

FIGURE 16.3
Subsequent Events



is necessary, auditors have two methods available for dating the audit report. They may *dual-date* their report “February 3, except for Note X, as to which the date is February 5.” Alternatively, they might decide to return to the client’s facilities for further review of subsequent events through the date of the subsequent event, February 5; in this case, the audit report would bear that date only.

Dual-dating extends the auditors’ responsibility for disclosure through the later date *only with respect to the specified item*. Using the later date for the date of the report extends the auditors’ responsibility with respect to all areas of the financial statements. Finally, in the unusual circumstance in which the client does not agree to properly reflect the event, the departure from generally accepted accounting principles may result in either a qualified or adverse opinion.

Figure 16.3 summarizes the auditors’ responsibilities for subsequent events with respect to the balance sheet date, the date of the audit report, and date the auditors grant the client permission to use the audit report—the **report release date**.

The Auditors’ S-1 Review in an SEC Registration

The Securities Act of 1933 (Section 11[a]) extends the auditors’ liability in connection with the registration of new securities with the Securities and Exchange Commission (SEC) to the *effective date* of the registration statement—the date on which the securities may be sold to the public. In many cases, the effective date of the registration statement may be several weeks or even months later than the date the auditors completed their field-work. Accordingly, on or as close as practicable to the effective date, the auditors return to the client’s facilities to conduct an **S-1 review**, so-called because of the “Form S-1” title of the traditional SEC registration statement for new securities issues. In addition to completing the subsequent events review described in the preceding section, the auditors should read the entire prospectus and other pertinent portions of the registration statement. They also should inquire of officers and other key executives of the client whether any events not reported in the registration statement have occurred that require amendment of the registration statement to prevent the audited financial statements therein from being misleading.

Obtain Representation Letter

Chapter 5 included a general description of the **representation letter** that the auditors should obtain from management. The primary purpose of the representation letter is to have the client’s principal officers acknowledge that they are primarily responsible for the fairness of the financial statements. Because the financial statements must reflect all

material subsequent events, the representation letter should be dated as of the date of the audit report. As indicated in Chapter 5, while representation letters are part of the audit evidence the auditors obtain, they are not a substitute for the application of other necessary audit procedures. Thus, for example, obtaining a management representation as to the reasonableness of the estimated allowance for doubtful accounts should not result in fewer other audit procedures relating to that account.

Communicate Misstatements to Management

Throughout the course of the audit, the auditors accumulate and communicate to management all **identified misstatements** other than those the auditors believe to be trivial.¹ Because the financial statements are the representations of management, management makes the final decision as to whether to approve and record any adjustments and disclosures. In some circumstances, management may propose alternative amounts for the adjustments and disclosures. Because the auditors' responsibility is to express an opinion on the financial statements, material unresolved differences between the auditors and management with respect to such adjustments are expected to result in modification of the auditors' report. Also, if any adjusting entries are not recorded, management must represent to the auditors (in the representation letter) that management believes the adjustments to be immaterial. Of course, the auditors should make their own conclusions about whether the amounts involved are material or immaterial.

Misstatements identified by the auditors may be categorized as factual misstatements, judgmental misstatements, or projected misstatements:

- **Factual misstatements (known misstatements)** are misstatements for which there is no doubt. For example, a \$50,000 overstatement of prepaid insurance is a factual misstatement because the auditor may precisely calculate the accurate amount. The appropriate adjusting journal entry in this case would be a debit to insurance expense for \$50,000 and a credit to prepaid insurance for the same amount.
- **Judgmental misstatements** arise from differences between the judgments of management and the auditors concerning accounting estimates, or the selection or application of accounting policies that the auditors consider inappropriate. The amount of a judgmental misstatement is the difference between management's amount and the closest amount that the auditors consider to be reasonable. As an example, assume that management estimates the company's warranty liability to be \$90,000, and the auditors estimate the liability to be between \$120,000 and \$140,000 with equal likelihood. The amount of the judgmental misstatement in this situation is \$30,000 (\$120,000 – \$90,000).²
- **Projected misstatements** are the auditors' estimate of misstatements arising from situations in which they used audit sampling to draw conclusions concerning the populations. As an example, if the book value of accounts receivable is \$6,250,000, and the auditors, using audit sampling, estimate the audited value to be \$6,100,000, the projected misstatement is \$150,000 (\$6,250,000 – \$6,100,000). However, because the projected misstatement includes the amount of actual errors discovered in the sample, the projected amount should be decreased by the amount of these factual misstatements. If the factual misstatements are not corrected by management, they are included with the other factual misstatements identified by the auditors. Alternately, if management corrects the factual amount, it is not included in the auditors' evaluation. To continue the above example, assume the actual misstatements found in the sample amounted to \$20,000 and management corrects the accounting records; \$130,000 (\$150,000 – \$20,000) remains as the projected misstatement.

¹ CPA firms often consider amounts of less than 3 percent or 5 percent of planning materiality (see Chapter 5) as being trivial.

² If audit evidence supports a point estimate of, say, \$125,000, the difference between \$125,000 and \$90,000 constitutes the misstatement, here \$35,000.

What do the auditors do if, after considering all of the misstatements, they conclude that the risk of material misstatement of the financial statements is too high? First, they should request that management record the adjustments needed to correct all *factual misstatements* other than those considered trivial. For *judgmental misstatements*, management should be asked to review the assumptions and methods it used in developing their estimate (e.g., the warranty liability); the auditors may then perform further audit procedures to reevaluate the reasonableness of the estimate after management has reconsidered its assumptions and methods.

For projected misstatements (generally arising from audit sampling), the auditors should request that management examine additional items in the account in order to identify and correct other misstatements. The auditors also may expand the scope of their audit procedures and reevaluate the reasonableness of the projected misstatement.

Evaluate Audit Findings

LO 16-8

Explain the steps involved in evaluating audit findings.

The auditors should evaluate the importance of all uncorrected misstatements identified individually and in the aggregate. Obviously, any individual misstatement or aggregated results that materially misstate the financial statements must be corrected, or the auditors cannot issue an unmodified opinion on the financial statements.³

In evaluating whether an individual misstatement is material, the auditors consider both quantitative and qualitative factors. For example, a \$10,000 related party transaction might be considered material for a particular audit, whereas a misstatement of trade accounts receivable of the same amount might not be considered material.

Immaterial misstatements that are discovered by the auditors and not corrected by the client are accumulated in the audit working papers. As discussed in detail in the next section, the auditors make a judgment as to whether the overall effect of these individually immaterial misstatements, plus the effect of possible undetected misstatements, is material.

Materiality—Considering Quantitative Factors

To issue an unmodified opinion, the auditors must conclude that there is a low level of risk of material misstatement of the financial statements. To make this conclusion, the auditors begin by reassessing materiality to determine whether it remains appropriate in the context of the client's actual financial results. Then, the auditors consider the **uncorrected misstatements** both individually and in the aggregate. As indicated previously, if the auditors conclude an individual uncorrected misstatement is material, they cannot issue an unmodified audit report. When the auditors estimate the total amount of uncorrected misstatements (factual, judgmental, and projected) to be material, they also will be unable to issue an unmodified report.

Often the auditors' estimate of uncorrected misstatements will be less than what they consider to be material. However, even in these situations, the risk of material misstatement may be too high. The closer the auditors' estimated total misstatements are to the material amount, the higher the risk that there may be undetected misstatements that cause the actual total misstatements to be material. Because the auditors must conclude there is a low risk of material misstatement, their estimate of the total misstatements has to be significantly less than a material amount for the auditors to issue an unmodified report.

The relationship between the aggregated misstatements and materiality is often documented in a working paper similar to that shown in Figure 16.4. That figure uses the three misstatements identified in the previous section, with the assumption that management has not corrected the \$50,000 factual misstatement relating to prepaid insurance but has corrected the \$20,000 factual misstatement related to accounts receivable.

Assume the auditors have established materiality at \$400,000 of net income after taxes. As illustrated, the auditors should consider the effects of the aggregated misstatements

³ As discussed in Chapter 6, the FASB considers a material misstatement to be one that is probable to change or influence the judgment of a reasonable person relying upon the information.

FIGURE 16.4 Aggregated Misstatements

Southmade Products Inc. Summary of Uncorrected Misstatements December 31, 20X7 Debit (Credit)										
Misstatements	Type	Assets		Liabilities		Income Statement				
		Current	Noncurrent	Current	Noncurrent	Revenue	Cost of Goods Sold	Selling, Gen., Admin.	Income	
Prepaid insurance	Factual	\$ (50,000)						\$ 50,000	\$ 50,000	
Warranty liability	Judgmental			\$ (10,000)	\$ (20,000)		\$ 30,000		\$ 30,000	
Accounts receivable	Projected	\$ (130,000)				\$ 130,000			\$ 130,000	
Total uncorrected		\$ (180,000)		\$ (10,000)	\$ (20,000)	\$ 130,000	\$ 30,000	\$ 50,000	\$ 210,000	
Tax effect at 40%				\$ 84,000					\$ (84,000)	
After-tax effect		\$ (180,000)	\$ –	\$ 74,000	\$ (20,000)	\$ 130,000	\$ 30,000	\$ 50,000	\$ 126,000	
Effect of prior year's uncorrected misstatements										
After-tax and prior year's effects		\$ (180,000)	\$ –	\$ 74,000	\$ (20,000)	\$ 130,000	\$ 30,000	\$ 50,000	\$ 26,000	
Totals per financial statements		\$42,000,000		\$22,000,000	\$8,000,000	\$63,000,000	\$41,500,000	\$15,000,000	\$6,206,000	
Percent of uncorrected to financial statements		–0.43%		0.34%	–0.25%	0.21%	0.07%	0.33%	2.03%	

Note: These misstatements are those presented in *Communicate Misstatements to Management* section of this chapter.



Illustrative Case

Offsetting Material Misstatements



While offsetting of material misstatements is not appropriate in most situations, the *AICPA Audit Guide: Assessing and Responding to Audit Risk in a Financial Statement Audit* provides the following example of a situation in which it might be considered appropriate:

A client failed to accrue for a purchase of office supplies. It also overestimated the accrual of contingent rent expense due for the year. If office supplies and rent expense are combined for the financial statements (for example, as "occupancy costs") and the accruals for both of these items are combined as accrued expenses it might be considered appropriate to offset the two misstatements.⁴

on net income and other components of the financial statements. In this case, the auditors compared the \$126,000 net income effect from Figure 16.4 (final column) with the \$400,000 material amount. They concluded that, given the size of the difference, \$274,000 (\$400,000 – \$126,000), a low level of risk exists that possible undetected misstatements, when combined with the aggregate of uncorrected misstatements, could exceed materiality. In a like manner, the auditors determined that a low level of risk of material misstatement exists for other financial statement items (e.g., specific accounts, current assets). If all are at appropriately low levels, the auditors will then conclude that sufficient appropriate audit evidence had been collected.

If the auditors' estimate of total uncorrected misstatements approaches materiality, they may conclude that the risk of material misstatement is too high to issue an unmodified opinion on the financial statements. For example, if materiality related to Figure 16.4 had been established at \$150,000 after taxes, the auditors would conclude that a greater than acceptably low level of risk exists that the financial statements are materially misstated. That is, even though they arrived at an accumulated misstatement of \$126,000 after taxes on Figure 16.4, they would conclude that there is too high of a likelihood that undetected misstatements may exist, resulting in the actual misstatements being more than \$150,000. In this situation, the auditors should consider the need to perform additional audit procedures from those that were originally planned. They also may try to reduce the amount of accumulated misstatements by persuading management to correct all of the factual misstatements.

Periodically auditors encounter a situation in which a client chooses to not correct two (or more) material misstatements because they in total offset one another. For example, a client's financial statements may overstate revenue by an amount that is completely offset by an overstatement of expenses (thus resulting in no misstatement of income). The professional standards state that it is unlikely that such offsetting is appropriate. An exception may be made in limited circumstances when the offset is within the same account balance or class of transactions. When any offsetting is present, the auditor may need to reassess the risks of material misstatements.

Materiality—Considering Qualitative Factors

While a schedule such as that presented in Figure 16.4 is helpful for assessing the quantitative effects of misstatements, auditors also should consider qualitative factors when evaluating the materiality of such misstatements. AICPA AU-C 320 and PCAOB AS 2105 provide numerous examples of such qualitative factors that may affect the evaluation of the materiality of misstatements. As examples, misstatements may be qualitatively material if they

- Arise from an item capable of precise measurement (e.g., the amount of a sale) rather than from an estimate (e.g., the amount in the allowance for doubtful accounts).
- Mask a change in earnings or other trends.

⁴ American Institute of Certified Public Accountants (AICPA), *AICPA Audit Guide: Assessing and Responding to Audit Risk in a Financial Statement Audit*, section 7.30.

- Hide a failure to meet analysts' consensus expectations for the company.
- Change a loss into income, or vice versa.
- Concern a particularly important segment or other portion of the registrant's business.
- Affect compliance with regulatory requirements, loan covenants, or other contractual requirements.
- Increase management's compensation.
- Involve concealment of an unlawful transaction.
- Are of an amount that management or the auditors believe would affect the stock's price.

In addition, the SEC requires that management and auditors apply a *reasonableness* standard when considering fairness of financial presentation. This somewhat ill-defined standard suggests that the need for proper presentation is not entirely a function of the above types of qualitative considerations. For example, the intentional misrecording of certain immaterial transactions might be considered unreasonable. Indeed, intentional misstatements may in some circumstances be unlawful; as such, they may require auditor consideration, as discussed in Chapter 2. Note that the situation being considered by the SEC in this case is one in which a client intentionally misrecorded items to manage earnings (e.g., reporting sales in the wrong year), as opposed to a situation in which an accounting expediency is being applied to an immaterial area (e.g., the expensing of immaterial office supplies rather than listing them as an asset).

Materiality—Considering the Effects of Prior-Year Uncorrected Misstatements

When uncorrected misstatements exist from prior years, should those misstatements be included in this year's materiality calculations? For example, assume that a client's previous year financial statements understated the estimated warranty payable by \$60,000, an immaterial amount. Furthermore, the auditors estimate that this year's accrual is understated by an additional \$70,000. In making materiality judgments, should the auditors consider only this year's \$70,000? Or should they consider the total of \$130,000 (\$70,000 + \$60,000)?

Historically, auditors have been allowed to use either of two approaches to make this decision: the **rollover approach** or the **iron curtain approach**. The *rollover approach* considers only the amount of the misstatement originating in the current year income statement—in this case, \$70,000. In contrast, the *iron curtain approach* considers the balance sheet effect of correcting the total misstatement existing at the end of the year, regardless of when the misstatement originated—in this case, \$130,000.

SEC *Staff Accounting Bulletin No. 108* decreased the auditor's flexibility in choosing between these methods by requiring that both the rollover and iron curtain approaches be considered. If either approach results in a material misstatement, an adjustment must be made. Thus, if the \$130,000 misstatement is considered material to the financial statements, the client's financial statements should be adjusted. The adjustment may be disaggregated as

- \$70,000 current-year effect.
- \$60,000 balance sheet carryover misstatement that originated in the preceding year.

The current-year financial statements should be adjusted for \$70,000. If the \$60,000 misstatement relating to the prior year (or years) is material to the current year, the prior-year financial statements should be adjusted, even if the amounts remain immaterial to those prior years. If the \$60,000 is immaterial to this year's financial statements, it may be included as an expense on this year's income statement rather than requiring restatement of the prior year's financial statements.

Evaluating the Risks of Material Misstatement

At or near the completion of fieldwork, the auditors should evaluate whether the accumulated results of their procedures and observations affect the assessments of the risks of

material misstatement made earlier in the engagement. In addition, the partner in charge of the engagement should determine that information or conditions indicative of risks of material misstatement due to fraud have been communicated to the audit team members.

Review the Financial Statement Disclosures

Throughout the audit, the auditors must recognize the need to determine that financial statement note disclosures are adequate. These disclosure requirements arise in numerous pronouncements of the Financial Accounting Standards Board, such as FASB ASC 450-20 on “Loss Contingencies” and FASB ASC 280-10-50 on reporting on segment information. In addition, the auditors should be aware of the requirements of AICPA *Statement of Position 94-6*, “Disclosure of Certain Significant Risks and Uncertainties.” That statement establishes disclosure requirements concerning (1) the nature of company operations, (2) the use of estimates in the preparation of financial statements, (3) certain significant estimates, and (4) current vulnerability due to concentrations (e.g., dependence upon a particular customer, supplier, or product).

It is not effective to rely on the auditors’ memories to evaluate the adequacy of disclosures, and it is not efficient for them to research the required disclosures each time they review a set of financial statements. Thus, many CPA firms use **disclosure checklists** that list all specific disclosures required by the FASB, the GASB, the FASAC, and the SEC. The auditors complete the checklist as a part of their review of the completed financial statements.

Review the Engagement

AICPA AU-C 300 and PCAOB AS 1201 require that the work of each assistant be reviewed to determine whether it was adequately performed and documented and to evaluate the results, relative to the conclusions to be presented in the auditors’ report.⁵ This review of the work of the audit staff is primarily accomplished through a review of the audit working papers. The seniors on audit engagements typically perform their review of the audit working papers as the papers are completed. While audit partners and managers will generally communicate with seniors and other staff members throughout the audit, their review of the working papers generally is not completed until near (or after) completion of fieldwork. The audit partner and manager will devote special attention to those accounts that have a higher risk of material misstatement, such as the significant accounting estimates of inventory obsolescence and warranty obligations. Also, a final consideration will be made of whether the results of procedures performed throughout the audit, including while completing the audit, identify conditions and events that indicate there could be substantial doubt about the company’s ability to continue as a going concern. Finally, if a second partner review is required by the CPA firm’s quality control policies, this review is usually performed just prior to issuance of the audit report.

Responsibilities for Other Information

Audited financial statements generally are included with annual reports to shareholders and in reports to the SEC. These documents may include a considerable amount of information in addition to the audited financial statements. In completing the audit engagement, the auditors must fulfill certain responsibilities regarding the additional information.

Other Information Included in Annual Reports

Other information is financial and nonfinancial information that is included in an annual report that contains audited financial statements, except it does not include required supplementary information (see next section).⁶ Examples of other information include a report by management discussing the year’s operating results, financial summaries or

⁵ AICPA AU-C 300 (PCAOB AS 1201).

⁶ In the case of a public company, it also includes “other documents to which the auditor, at the client’s request, devotes attention” (PCAOB AS 2710.02). It does not include financial statements and audit reports appearing in a Securities Act of 1933 registration statement (see Chapter 4).

highlights, employment data, planned capital expenditures, financial ratios, and names of officers and directors. The professional standards (AICPA AU-C 720; PCAOB AS 2710) require auditors to read this information for inconsistencies with the audited financial statements. While reading the other information, the auditors should be alert for any indications that a material misstatement of fact exists or that the other information is otherwise misleading. For a public company audit report, no additional section is required in the audit report when no inconsistencies or misstatements are identified. For a nonpublic company, if no inconsistencies or misstatements are identified, the auditors add an Other Information section so indicating (see nonpublic company standard audit report in Chapter 2 or 17) at an appropriate place, following the basis for opinion section as shown below.

Other Information

Management is responsible for the other information included in the annual report. The other information comprises the [information included in the annual report] but does not include the financial statements and our auditor's report thereon. Our opinion on the financial statements does not cover the other information and we do not express an opinion or any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and consider whether a material inconsistency exists between the other information and the financial statements or the other information otherwise appears to be materially misstated. If, based on the work performed, we conclude that an uncorrected material misstatement of the other information exists, we are required to describe it in our report.

If misstatements of the other information are identified, the nonpublic and public company standards require similar responses. The auditors first request the client to revise any incorrect information. If the client refuses, and the other information is incorrect, this will lead to (1) withdrawing from the engagement, (2) withholding the auditors' report, or (3) a statement in the audit report that the auditor has concluded that the other



Illustrative Case

Non-GAAP Financial Measures



Non-GAAP financial measures are numerical financial statement measures that are GAAP

financial amounts adjusted in some fashion. For example, a non-GAAP financial measure may be the result of adjusting GAAP-based earnings in a way that management believes might be useful to financial statement users. Because these measures are often presented in documents that also include audited financial statements (e.g., included in an annual report as a part of management's discussion and analysis, or as separate schedules), they are part of the "other information" discussed in this section. Releasing such measures as a supplement to GAAP measures has become quite popular—for example, one investment analysis found that over 90 percent of the Standard & Poor's 500 companies did so.

Ideally, such non-GAAP financial measures provide additional insights about a company's results of operations, financial position, or liquidity. But these measures present potential problems. Because various companies use differing measures, intercompany comparisons of such adjusted numbers may be difficult or impossible. Also, companies may change the measures used between periods or only present those that reflect positively upon the company.

A number of these measures have been questioned, including these:

- Groupon Inc. at one point used a non-GAAP profit measure that excluded its marketing costs.
- Microsoft Company adjusted deferred revenues relating to its rollout of Windows 10, reporting a non-GAAP measure that was approximately 32 percent higher than its GAAP result.
- Other companies have recorded sales when billed, as contrasted to delivery of the goods or services.

The SEC has been active in regulating such disclosures as it has attempted to eliminate what it considers to be "misleading" measures.

The auditor's responsibility when such information is included as other information in a document containing audited financial statements is to read the information for inconsistencies with the financial statements. When the non-GAAP disclosures are included in a document or presentation that does not contain audited financial statements (e.g., a press release), the auditors ordinarily have no such responsibility.

information is materially misstated and a description of the misstatement (ordinarily in the above other information section). If, instead, the financial statements are determined to be materially misstated, the situation will be treated as a departure from GAAP, resulting in either a qualified or adverse opinion. Also, the auditors may consider it appropriate to seek legal advice when management refuses to correct misstated information.

Required Supplementary Information

Certain organizations are required by a designated accounting standards setter (i.e., FASB, GASB, FASAB, IASB) to present supplementary information. Such **required supplementary information**, while not considered a part of the general purpose financial statements, is required to be presented as unaudited supplementary schedules accompanying the financial statements. AICPA AU-C 730 and PCAOB AS 2705 require auditors to apply the following procedures to this information:

- *Inquire* of management about methods of preparing information, including whether (1) it was prepared following prescribed guidelines, (2) methods of measurement or presentation have changed from the prior period, and (3) there were any significant assumptions or interpretations underlying the measurement or presentation of the information.
- *Compare information* for consistency with (1) management's responses to the inquiries, (2) the basic financial statements, and (3) other knowledge obtained during the audit.
- *Obtain written representations* from management (1) acknowledging its responsibility for the information, (2) about whether the information is measured within guidelines, (3) about whether the methods have changed, and (4) about any significant assumptions or interpretations.

When no significant exceptions are identified, the reporting responsibilities differ between the AICPA and PCAOB standards. The AICPA standards require inclusion of a Supplementary Information section in the financial statement audit report indicating that the procedures were performed; the section provides no assurance. Under PCAOB standards (PCAOB AS 2705.03), while an explanatory paragraph may be added to the audit report, such a paragraph is not required.

When the supplementary information is omitted or improperly stated, under both AICPA and PCAOB standards, the situation is described in a section (explanatory paragraph per PCAOB standards). Unless the financial statements are misstated, the Opinion section (explanatory paragraph) of the report is not modified because the supplementary information is not considered a part of the audited information.

Supplementary Information in Relation to the Financial Statements as a Whole

AICPA AU-C 725 and PCAOB AS 2701 provide guidance on a nonrequired form of auditor association with **supplementary information** that goes beyond that described in the preceding two sections. With this service, auditors perform procedures to allow them to provide assurance on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. While the supplementary information may be presented in a document containing audited financial statements or separately from the financial statements, it must be derived from, and relate directly to, the underlying accounting and other records. Examples of information derived from the underlying accounting records include consolidating information, historical summaries of accounts, and statistical data. Examples for regulated companies (e.g., brokers and dealers) include SEC rules regarding maintenance of minimum net capital and reserve requirements. To provide this assurance, the auditors should perform the following procedures:

- Inquire of management about the purpose of the information and criteria used to prepare it.
- Determine the propriety of the form and content of the information, including whether it complies with any relevant regulatory requirements.
- Obtain an understanding of how the information was prepared.
- Compare and reconcile information to underlying accounting and other records.

- Inquire of management concerning significant assumptions.
- Evaluate the appropriateness and completeness of the information.
- Obtain written representations.

When the information is found to be fairly stated in relation to the financial statements, a Supplementary Information section (explanatory paragraph) is added describing the procedures followed and including an opinion that “the information is fairly stated in all material respects in relation to the financial statements as a whole.” If the auditors conclude that the information is not fairly stated in all material respects, the section (explanatory paragraph) so states. Unless the financial statements are misstated, the Opinion section of the audit report is not modified because the supplementary information is not considered a part of the audited information.

Figure 16.5 summarizes the reporting standards for both other information and supplementary information.

Opinion Formulation and Report Issuance

After the preceding procedures have been performed, the auditors will ordinarily be in a position to issue their audit report. When the auditors have obtained reasonable assurance that the financial statements follow generally accepted accounting principles and the audit has been performed in conformity with generally accepted auditing standards, including no significant scope limitations, an unqualified opinion will ordinarily be issued. As we will discuss in Chapter 17, when various circumstances have occurred (e.g., changes in accounting principles, substantial doubt about the entity’s ability to continue as a going concern, and when other auditors are involved), explanatory language may be added to the audit report.

Additional Communications

Auditors should communicate certain matters relating to fraud, illegal acts, reportable conditions, and certain other matters to the audit committee or the equivalent group with responsibility for oversight of the financial reporting process. All the communications may be communicated either orally or in writing.

FIGURE 16.5 Summary of Other Information in Annual Reports and Supplemental Information Reporting

Circumstance	Effect on Reporting if Properly Presented	Effect on Reporting if Improperly Presented
Other information in annual reports containing audited financial statements	AICPA: Include an Other Information section (as per text illustration). PCAOB: No report modification required; the option to provide such information is not addressed in the standard.	AICPA or PCAOB: The section (paragraph) indicates that the information is incorrect or omitted, as appropriate. The audit opinion remains unmodified unless the audited information is misstated, in which case a qualified or adverse opinion is appropriate. These situations may also lead to auditor resignation.
Required supplementary information	AICPA: Add a Required Supplementary Information section; the section provides no assurance on the required supplemental information. PCAOB: No report modification required, although the auditors may choose to add a paragraph providing no assurance on the required supplemental information.	
Supplementary information in relation to the financial statements as a whole	AICPA: Add a Supplementary Information section; the section includes an opinion on whether the information is fairly stated in all material respects in relation to the financial statements as a whole. Alternatively, a separate report on the supplementary information may be issued. PCAOB: Requirements similar to AICPA with an explanatory paragraph or a separate report.	



Fraud and Illegal Acts

The professional standards (AICPA AU-C 240, 250; PCAOB AS 2401, 2405) require that the audit committee be informed about fraudulent or illegal acts that the auditors become aware of, unless those acts are clearly inconsequential. Although these disclosures are also normally made to management, when management is believed to be involved with such an act, the communications should be made directly to the audit committee.

Significant Deficiencies

Recall from our discussion in Chapter 7 that the professional standards (AICPA AU 265; PCAOB AS 1305) require that the auditors communicate to the audit committee any significant deficiencies in internal control (previously known as reportable conditions).

Other Communications

AICPA AU-C 260 and PCAOB AS 1301 require an oral or written communication of certain information to those charged with governance of the company being audited. Those charged with governance means those with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity—this ordinarily includes the board of directors or audit committee. The communication is aimed at providing information related to corporate governance matters related to the financial statement audit that are significant and relevant for overseeing the financial reporting process. It includes information on

- The auditors' responsibility under generally accepted auditing standards (i.e., to form and express an opinion) and management's responsibilities.
- An overview of the planned scope and timing of the audit.
- Significant findings from the audit.

The discussion of significant findings from the audit is particularly complex in that it involves communication of qualitative aspects of the company's significant accounting practices, significant unusual transactions, audit difficulties encountered, difficult issues, required consultation outside the engagement team, uncorrected misstatements, disagreements with management, management consultations with other accountants, auditor independence issues, and other significant issues.

The requirements regarding the communication of AICPA AU-C 260 and PCAOB AS 1301 are very similar. One difference is that the PCAOB requires that the communication occur prior to issuance of the auditors' report; AICPA AU-C 260 requires the communication on a timely basis.

Finally, as discussed in detail in Chapter 17, audit reports of public companies are required to include discussion of any critical audit matters identified during the audit. Those matters are selected from among those matters communicated or required to be communicated to the audit committee that related to material accounts or disclosures involving especially challenging, subjective, or complex auditor judgment. Audit reports of nonpublic companies are not required to include a discussion of key audit matters, but they may be included in the auditors' report.

Post-Audit Responsibilities

The Auditors' Subsequent Discovery of Facts Existing at the Date of Their Report

After the issuance of its audit report, a CPA firm may encounter evidence indicating that the client's financial statements were materially misstated or lacked required disclosures. The relevant professional standards for these situations are AICPA AU-C 560 and PCAOB AS 2905.

The auditors should immediately investigate such subsequently discovered facts. If the auditors determine that the facts are significant and existed at the date of the audit report, they should advise the client to make appropriate disclosure of the facts to anyone actually or likely to be relying upon the audit report and the related financial statements.

	Illustrative Case	Primary Issues Requiring Companies to Restate Financial Statements
An analysis of circumstances resulting in restatement of financial statements reveals the following as frequent causes: • Revenue recognition issues. • Debt, quasi-debt, warrants, and equity security issues (including derivatives). • Tax expenses. • Cash flow statement classification errors. • Acquisitions, mergers, disposals, and reorganization accounting issues. • Accounts/loans receivable, investments, and cash issues. • Liabilities, payable, reserves, and accrual estimate failures. • Deferred stock-based and/or executive compensation issues.		

LO 16-9

Discuss the auditors' post-audit responsibilities.

For a public company in the United States, disclosure that a financial statement should no longer be relied upon is ordinarily through the client's filing of a Form 8-K with the SEC. If the client refuses to make appropriate disclosure, the CPAs should inform each member of the client's board of directors of such refusal. They also should notify regulatory agencies having jurisdiction over the client, and, if practicable, each person known to be relying upon the audited financial statements, that the CPAs' report can no longer be relied upon.

Subsequent Discovery of Omitted Audit Procedures

What actions should the auditors take if, after issuing an audit report, they find that they failed to perform certain significant audit procedures? The omission of appropriate audit procedures in a particular engagement might be discovered during a peer review or other subsequent review of the auditors' working papers. Unlike the situation described in the previous section, the auditors do not have information indicating that the financial statements are in error. Instead, the subsequent review has revealed that they may have issued their audit report without having gathered sufficient audit evidence. In addressing this sensitive problem, AICPA AU-C 585 and PCAOB AS 2901 require that the auditors should assess the importance of the omitted procedures to their previously issued opinion. If they believe that the omitted procedures impair their ability to support their previously issued opinion, and their report is still being relied upon by third parties, they should attempt to perform the omitted procedures or appropriate alternative procedures. If those procedures are performed and reveal facts that may have caused revision to the audit report had they been known, the auditors should follow the procedures presented in AICPA AU-C 560 or PCAOB AS 2905 (described in the preceding text section). Alternatively, if performance of the omitted or appropriate alternative procedures is not possible, the firm should consider consulting legal counsel. Also, depending upon the circumstances, the firm should consider the need to inform regulatory authorities and users relying, or likely to rely on the audit report.

Chapter Summary

This chapter explained auditing operations and the considerations and procedures involved in completing the audit. To summarize:

1. The analysis throughout the text has emphasized the need to consider revenue and expense accounts in conjunction with the audit of asset and liability accounts. However, vouching and other substantive procedures are generally necessary for revenue and expense accounts that are less directly associated with transaction cycles, such as miscellaneous revenue and selling, general, and administrative expenses.
2. Substantive procedures for payroll accounts address the overall reasonableness of payroll costs and the proper allocation of these costs to the functional areas of

manufacturing, selling, and administration. In addition, tests should be performed on the allocation of manufacturing costs to work in process, finished goods, and cost of goods sold.

3. Because of their objectives, certain audit procedures cannot be completed before the end of the audit. These procedures include (a) searching for unrecorded liabilities, (b) reviewing the minutes of meetings, (c) performing final analytical procedures, (d) performing procedures to identify loss contingencies, (e) performing the review for subsequent events, and (f) obtaining the representation letter.
4. The auditors should perform audit procedures to determine that loss contingencies have been properly presented and disclosed. To identify loss contingencies, auditors perform various procedures, such as reviewing minutes of directors' meetings, inquiring of the client's lawyer, reviewing correspondence with financial institutions and regulatory agencies, sending confirmations to financial institutions, and obtaining a representation letter from officers of the company.
5. Subsequent events may be classified into two broad categories: (a) those providing additional evidence as to conditions that existed at the date of the financial statements (which may require adjusting entries) and (b) those that arose after the date of the financial statements (which may require note disclosures). Many of these subsequent events relate to loss contingencies, and the audit procedures involved are similar to the ones used to audit those items.
6. To issue an unmodified opinion, the auditors must conclude that there is a low level of risk of material misstatement of the financial statements. In considering whether they have sufficient appropriate audit evidence to support such an assessment, they consider whether uncorrected misstatements (factual, judgmental, and projected) plus an allowance for undetected misstatements have an immaterial effect individually and in the aggregate. In addition, the auditors should consider whether any audit results indicate a need to reassess the level of materiality or the risk of material misstatement.
7. Auditors also have certain post-audit responsibilities. When auditors find, subsequent to the issuance of their audit report, that the financial statements are materially misleading, they should take steps to prevent continued reliance on their report. In some cases, this might involve notification of regulatory agencies.

Key Terms Introduced or Emphasized in Chapter 16

Analytical procedures (740) Evaluations of financial information made by a study of plausible relationships between financial and nonfinancial information.

Commitment (743) A contractual obligation to carry out a transaction at specified terms in the future. Material commitments should be disclosed in the financial statements.

Conservatism (729) An accounting doctrine for asset valuation in which the lower of two alternative acceptable asset valuations is chosen.

Contingent liability (740) A possible liability, stemming from past events, that will be resolved as to existence and amount by some future event.

Date of the financial statements (744) The date of the end of the latest period covered by the financial statements (e.g., date of the balance sheet).

Disclosure checklist (753) A list of specific disclosures required by the FASB, the GASB, the FASAC, and the SEC that is used to evaluate the adequacy of the disclosures in a set of financial statements.

Emphasis-of-matter (745) A section (paragraph) included in the nonpublic company auditors' report that is required by GAAS or is included at the auditors' discretion, and that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditors' judgment, is of such importance that it is fundamental to users' understanding of the financial statements (e.g., a lack of consistent application of GAAP). For public companies, as discussed in detail in Chapter 17, the terms *explanatory paragraph* and *emphasis-of-a-matter paragraph* are used.

Factual misstatements (748) Misstatements about which there is no doubt; for example, failure to record a purchase during the period. Previously, the auditing literature referred to factual misstatements as *known misstatements*. Misstatements may be categorized as *factual misstatements*, *judgmental misstatements*, and *projected misstatements*—see the definitions of each.

General risk contingency (743) An element of the business environment that involves some risk of a future loss. Examples include the risk of accident, strike, price fluctuations, or natural catastrophe. General risk contingencies should not be disclosed in financial statements.

Identified misstatements (748) Misstatements found by the auditors during their audit. These misstatements may or may not be corrected by management. Misstatements may be categorized as *factual misstatements*, *judgmental misstatements*, and *projected misstatements*—see the definitions of each.

Iron curtain approach (752) An approach to making materiality judgments that quantifies the total likely misstatement as of the current year-end based on the effects of reflecting all misstatements (including projecting misstatements where appropriate) existing in the balance sheet at the end of the current year, irrespective of whether the misstatements occurred in the current year or previous years. For example, if expenses were understated by \$20,000 in the previous year and \$45,000 during the current year, the iron curtain method would quantify the misstatement as \$65,000. Also see *rollover approach*.

Judgmental misstatements (748) Differences arising from the judgments of management concerning accounting estimates that the auditor considers unreasonable or the selection or application of accounting policies that the auditor considers inappropriate. For example, a difference related to the appropriate amount in the allowance for doubtful accounts. Misstatements may be categorized as *factual misstatements*, *judgmental misstatements*, and *projected misstatements*—see the definitions of each.

Known misstatements (748) The auditing literature now refers to these as *factual misstatements* (see that term). Misstatements may be categorized as *factual misstatements*, *judgmental misstatements*, and *projected misstatements*—see the definitions of each.

Letter of inquiry (of the client's lawyer) (741) A letter sent by auditors to a client's legal counsel requesting a description and evaluation of pending or threatened litigation, unasserted claims, and other loss contingencies. The returned letter from the lawyer is referred to as the lawyer's letter.

Loss contingency (740) A possible loss, stemming from past events, that will be resolved as to existence and amount by some future event. Loss contingencies should be disclosed in notes to the financial statements if there is a reasonable possibility that a loss has been incurred. When loss contingencies are considered probable and can be reasonably estimated, they should be accrued in the accounts.

Management review controls (730) Reviews conducted by management of estimates and other kinds of financial information for reasonableness. They often involve the use of significant judgment, knowledge, and experience in comparing recorded amounts with expectations of the reviewers. They often are considered monitoring controls but may relate to any of the other COSO components that have the common characteristic of management review of information to identify misstatements or breakdowns in other controls.

Minutes (740) A formal record of the issues discussed and actions taken in meetings of stockholders and the board of directors.

Misstatements (740) Differences between the amount, classification, presentation, or disclosure of reported financial statement items and the amount, classification, presentation, or disclosure that is required for the items to be presented fairly in accordance with the applicable financial reporting framework. Misstatements can arise from fraud or error. Misstatements may be categorized as *factual misstatements*, *judgmental misstatements*, and *projected misstatements*—see the definitions of each.

Other information (753) Financial and nonfinancial information (other than the financial statements and the auditors' report thereon) included in an entity's annual report.

Projected misstatements (748) The auditors' best estimate of the misstatement in populations involving the projection of misstatements identified in audit samples to entire populations from which the samples were drawn; for example, a difference in the total accounts receivable based on a projection of sample results to the entire population of accounts receivable. Projected misstatements are sometimes referred to as *known likely misstatements*. Misstatements may be categorized as *factual misstatements*, *judgmental misstatements*, and *projected misstatements*—see the definitions of each.

Report release date (747) The date the auditors grant the client permission to use the audit report in connection with the financial statements. This is sometimes referred to as the date of issuance of the audit report.

Representation letter (747) A single letter or separate letters prepared by officers of the client company at the auditors' request setting forth certain representations about the company's financial position or operations.

Required supplementary information (755) Information that a designated accounting standards setter requires to accompany an entity's basic financial statements. Required supplementary information differs from other types of information outside the basic financial statements because a designated accounting standards setter considers the information an essential part of the financial reporting of certain entities and because authoritative guidelines for the measurement and presentation of the information have been established.

Rollover approach (752) An approach to making materiality judgments that quantifies the total likely misstatement as of the current year-end based on the effects of reflecting misstatements (including projecting misstatements where appropriate) only during the current year. For example, if expenses were understated by \$20,000 in the previous year, and \$45,000 during the current year, the rollover method would quantify the misstatement as \$45,000, ignoring the previous year misstatement. Also see *iron curtain approach*.

S-1 review (747) Procedures carried out by auditors at the client company's facilities on or as close as practicable to the effective date of a registration statement filed under the Securities Act of 1933.

Subsequent event (744) An event occurring between the date of the financial statements and the date of the auditor's report.

Supplementary information (755) Information presented outside the basic financial statements, excluding required supplementary information, that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Such information may be presented in a document containing the audited financial statements or separate from the financial statements.

Unasserted claim (741) A possible legal claim of which no potential claimant has exhibited an awareness.

Uncorrected misstatements (749) Misstatements that have not been reflected in the financial statements. Ordinarily these are misstatements the auditors have identified and for which proposed adjusting entries have not been recorded.

Review Questions

- 16-1. Identify three revenue accounts that are verified during the audit of balance sheet accounts; also, identify the related balance sheet accounts.
- 16-2. How are analytical procedures used in the verification of revenue?
- 16-3. Identify three items often misclassified as miscellaneous revenue.
- 16-4. Identify three expense accounts that are verified during the audit of balance sheet accounts; also, identify the related balance sheet accounts.
- 16-5. For which expense accounts should the auditors obtain or prepare analyses to be used in preparation of the client's income tax returns?
- 16-6. When you are first retained to audit the financial statements of Wabash Company, you inquire whether a budget is used to control costs and expenses. The controller, James Lowe, replies that he personally prepares such a budget each year but that he regards it as a highly confidential document. He states that you may refer to it if necessary, but he wants you to make sure that no employee of the firm sees any of the budget data. Comment on this use of a budget.
- 16-7. What auditing procedure can you suggest for determining the reasonableness of selling, general, and administrative expenses?
- 16-8. Describe how the auditors use analytical procedures in the examination of selling, general, and administrative expenses.
- 16-9. What division of duties among independent departments is desirable to achieve maximum internal control over payroll?
- 16-10. What safeguards should be employed when the inaccessibility of banking facilities makes it desirable to pay employees in cash?
- 16-11. You are asked by a client to outline the procedures you would recommend for handling of unclaimed wages. What procedures do you recommend?
- 16-12. What specific procedures are suggested by the phrase "test of controls over payroll transactions"?

- 16-13. Should the auditors make a complete review of all correspondence in the client's files? Explain.
- 16-14. What is the purpose of analytical procedures performed as a part of the overall review?
- 16-15. List the audit procedures that should be completed near the date of the audit report.
- 16-16. What are *loss contingencies*? How are such items presented in the financial statements? Explain.
- 16-17. What is the usual procedure followed by the CPA in obtaining evidence regarding pending and threatened litigation against the client?
- 16-18. Explain how a loss contingency exists with respect to an *unasserted* claim. Should unasserted claims be disclosed in the financial statements?
- 16-19. If the federal income tax returns for prior years have not as yet been reviewed by federal tax authorities, would you consider it necessary for the client to disclose this situation in a note to the financial statements? Explain.
- 16-20. What is the meaning of the term *commitment*? Give examples. Do commitments appear in financial statements? Explain.
- 16-21. What are *general risk contingencies*? Do such items require disclosure in the financial statements?
- 16-22. What are *subsequent events*?
- 16-23. Describe the manner in which the auditors evaluate their audit findings.
- 16-24. Describe a disclosure checklist. What is its purpose?
- 16-25. When the auditors have audited the financial statements, what is their responsibility with respect to other information (not including required supplemental information) included in an annual report to shareholders?
- 16-26. Does incorrect required supplemental information included with audited financial statements result in a qualified or adverse audit opinion? Explain.

Questions

Requiring Analysis

Select questions are available with Connect



- LO 16-7** 16-27. In your audit of the financial statements of Wolfe Company for the year ended April 30, you find that a material account receivable is due from a company in reorganization under Chapter 11 of the Bankruptcy Act. You also learn that on May 28 several former members of the bankrupt company's management formed a new company and that the new company had issued a note to Wolfe Company that it would pay off the bankrupt customer's account receivable over a four-year period. What presentation, if any, should be made of this situation in the financial statements of Wolfe Company for the year ended April 30? Explain.
- LO 16-5** 16-28. OA Company recently hired a payroll service provider to process its payroll—that service provider has essentially taken over the payroll function, and payroll represents OA's largest expense. Comment on the following statement: OA's auditors should make certain that the payroll service provider's most recent financial statements are audited, and that the related audit report includes no indication of a weakness in internal control related to processing its own payroll.
- LO 16-6** 16-29. During an audit engagement, Robert Wong, CPA, has satisfactorily completed an examination of accounts payable and other liabilities and now plans to determine whether there are any loss contingencies arising from litigation, claims, or assessments.

What are the audit procedures Wong should follow with respect to the existence of loss contingencies arising from litigation, claims, or assessments? Do not discuss reporting requirements.
- LO 16-6, 7** 16-30. You are the audit manager in the audit of the financial statements of Midwest Grain Storage Inc., a new client. The company's records show that, as of the balance sheet date, approximately 15 million bushels of various grains are in storage for the Commodity Credit Corporation, an agency of the U.S. government.

In your review of the audit senior's working papers, you ascertain the following facts:

 - a. All grain is stored under a Uniform Grain Storage Agreement, which holds Midwest responsible for the quantity and quality of the grain.
 - b. Losses due to shrinkage, spoilage, and so forth are inherent in the storage of grain. Midwest's losses, however, have been negligible due to the excellence of its storage facilities.
 - c. Midwest carries a warehouseman's bond covering approximately 20 percent of the value of the stored grain.

In the loss contingencies section of the working papers, the senior auditor has made the following notation: "I propose recommending to Midwest's controller that the contingent liability for grain spoilage and shrinkage be disclosed in a note to the financial statements."⁷

Do you concur with the senior's proposal? Explain.

LO 16-1, 2, 3 16-31.

	Sales	Cost of Sales	Gross Margin Percentage	Industry Averages
New Course Books	\$ 1,086,800	\$ 742,567		25.4
Used Course Books	468,200	318,222		32.6
Custom Published Books	212,222	159,293		25.6
Textbook Rental Sales	102,323	90,323		22.1
Course Technology	90,600	80,432		11.2
Trade Books	68,400	40,356		24.3
Professional Reference Books	22,330	15,200		31.0
Total Book Sales	\$2,050,875	\$1,446,393		26.5
Total Nonbook Sales	\$ 823,578	\$ 612,233		29.7
Total Net Sales	\$2,874,453	\$2,058,626		28.3

- Calculate the gross margin percentage for each of State University's product lines.
- Compare State University's gross margins to industry averages. Indicate any margins that appear out of line, in relation to the industry.

LO 16-7 16-32. The auditor's opinion on the fairness of financial statements may be affected by subsequent events.

- Define what is commonly referred to in auditing as a *subsequent event*, and describe the two general types of subsequent events.
- Identify those auditing procedures that the auditor should apply at or near the completion of fieldwork to disclose significant subsequent events.

LO 16-6, 7 16-33. Linda Reeves, CPA, receives a telephone call from her client, Lane Company. The company's controller states that the board of directors of Lane has entered into two contractual arrangements with Ted Forbes, the company's former president, who has recently retired. Under one agreement, Lane Company will pay the ex-president \$7,000 per month for five years if he does not compete with the company during that time in a rival business. Under the other agreement, the company will pay the ex-president \$5,000 per month for five years for such advisory services as the company may request from the ex-president.

Lane's controller asks Reeves whether the balance sheet as of the date the two agreements were signed should show \$144,000 in current liabilities and \$576,000 in long-term liabilities, or whether the two agreements should be disclosed in a contingencies note to the financial statements.

How should Linda Reeves reply to the controller's questions? Explain.

LO 16-8 16-34. Justin Kealey, CPA, is auditing Tustin Companies Inc. Kealey has accumulated factual, judgmental, and projected misstatements for the current year to evaluate whether there is a sufficiently low risk of material misstatement of the financial statements to issue an opinion. However, Kealey notes that there are several misstatements that have been carried over from prior years.

- Distinguish between the *iron curtain* and the *rollover* approaches to considering the misstatements from prior years.
- Describe how SEC *Staff Accounting Bulletin No. 108* requires auditors to consider misstatements carried over from prior periods.

⁷ Ray Whittington and Kurt Pany, *Principles of Auditing and Other Assurance Services* (New York: McGraw-Hill/Irwin, 2006).

- LO 16-7, 9** 16–35. On July 27, 20X0, Arthur Ward, CPA, issued an unqualified audit report on the financial statements of Dexter Company for the year ended June 30, 20X0. Two weeks later, Dexter Company mailed annual reports, including the June 30 financial statements and Ward's audit report, to 150 stockholders and to several creditors of Dexter Company. Dexter Company's stock is not actively traded on national exchanges or over the counter.

On September 5, the controller of Dexter Company informed Ward that an account payable for consulting services in the amount of \$170,000 had inadvertently been omitted from Dexter's June 30 balance sheet. As a consequence, net income for the year ended June 30 was overstated by \$90,500, net of applicable federal and state income taxes. Both Ward and Dexter's controller agreed that the misstatement was material to Dexter's financial position at June 30, 20X0, and operating results for the year then ended.

What should Arthur Ward's course of action be in this matter? Discuss.

- LO 16-8** 16–36. Linda Tanner, CPA, is auditing the Carson Company. For the current year, Carson is presenting December 31, 20X5, financial statements with comparative financial statements for the year ended December 31, 20X4. In the prior year audit, Linda identified an understatement of prepaid expenses of \$100,000 at December 31, 20X4, that was not corrected. In the current year, Linda found that prepaid expenses were understated by another \$50,000 at December 31, 20X5.
- Using the *iron curtain* approach, describe how Tanner would consider whether an adjustment is required.
 - Using the *rollover* approach, describe how Tanner would consider whether an adjustment is required.
 - Describe what SEC *Staff Accounting Bulletin No. 108* requires in this situation.

Objective Questions

LO 16-5

16–37. Multiple Choice Questions

Select the best answer for each of the following and give reasons for your choice:

LO 16-5

- Which of the following is *least* likely to be considered a substantive procedure relating to payroll?
 - Investigate fluctuations in salaries, wages, and commissions.
 - Test computations of compensation under profit sharing for bonus plans.
 - Test commission earnings.
 - Test whether employee time reports are approved by supervisors.
- Which of the following is the *best* way for the auditors to determine that every name on a company's payroll is that of a bona fide employee presently on the job?
 - Examine human resources records for accuracy and completeness.
 - Examine employees' names listed on payroll tax returns for agreement with payroll accounting records.
 - Make a surprise observation of the company's regular distribution of paychecks on a test basis.
 - Visit the working areas and verify that employees exist by examining their badge or identification numbers.

LO 16-6

- As a result of analytical procedures, the independent auditors determine that the gross profit percentage has declined from 30 percent in the preceding year to 20 percent in the current year. The auditors should:
 - Express an opinion that is qualified due to the inability of the client company to continue as a going concern.
 - Evaluate management's performance in causing this decline.
 - Require note disclosure.
 - Consider the possibility of a misstatement in the financial statements.

LO 16-5

- When auditing the statement of cash flows, which of the following would an auditor *not* expect to be a source of receipts and payments?
 - Capitalization.
 - Financing.
 - Investing.
 - Operations.

LO 16-6

e. The search for unrecorded liabilities for a public company includes procedures usually performed through the:

- (1) Day the audit report is issued.
- (2) End of the client's year.
- (3) Date of the auditors' report.
- (4) Date the report is filed with the SEC.

LO 16-8

f. The aggregated misstatement in the financial statements is made up of:

	Factual Misstatements	Projected Misstatements	Judgmental Misstatements
(1)	Yes	Yes	Yes
(2)	Yes	Yes	No
(3)	No	Yes	No
(4)	No	Yes	Yes

LO 16-6

g. A possible loss, stemming from past events that will be resolved as to existence and amounts, is referred to as a(n):

- (1) Analytical process.
- (2) Loss contingency.
- (3) Probable loss.
- (4) Unasserted claim.

LO 16-7

h. Which of the following is most likely to be considered a Type 1 subsequent event?

- (1) A business combination completed after year-end, but for which negotiations began prior to year-end.
- (2) A strike subsequent to year-end due to employee complaints about working conditions that originated two years ago.
- (3) Customer checks deposited prior to year-end but determined to be uncollectible after year-end.
- (4) Introduction of a new line of products after year-end for which major research had been completed prior to year-end.

LO 16-6

i. An auditor accepted an engagement to audit the 20X8 financial statements of EFG Corporation and began the fieldwork on September 30, 20X8. EFG gave the auditor the 20X8 financial statements on January 17, 20X9. The auditor completed the audit on February 10, 20X9, and delivered the report on February 16, 20X9. The client's representation letter normally would be dated:

- (1) December 31, 20X8.
- (2) January 17, 20X9.
- (3) February 10, 20X9.
- (4) February 16, 20X9.

LO 16-8

j. Which of the following procedures is most likely to be included near completion of an audit?

- (1) Obtaining an understanding of internal control.
- (2) Confirmation of receivables.
- (3) Observation of inventory.
- (4) Performing analytical procedures.

LO 16-9

k. Subsequent to the issuance of the auditor's report, the auditor became aware of facts existing at the report date that would have affected the report had the auditor then been aware of such facts. After determining that the information is reliable, the auditor should next:

- (1) Notify the board of directors that the auditor's report must no longer be associated with the financial statements.
- (2) Determine whether there are persons relying or likely to rely on the financial statements who would attach importance to the information.
- (3) Request that management disclose the effects of the newly discovered information by adding a footnote to subsequently issued financial statements.
- (4) Issue revised pro forma financial statements taking into consideration the newly discovered information.

LO 16-7

l. Which of the following events occurring on January 5, 20X2, is most likely to result in an adjusting entry to the 20X1 financial statements?

- (1) A business combination.
- (2) Early retirement of bonds payable.
- (3) Settlement of litigation.
- (4) Plant closure due to a strike.

LO 16-7 16–38. Adapted AICPA Task-Based Simulation

The following situations represent excerpts from the responses to audit inquiries of external legal counsel of XYZ Co. during the annual audit of year 1 (“legal response”). For each excerpt, select the most appropriate financial statement effect and audit response. Each excerpt is independent. Responses may be used once, more than once, or not at all.

- a. The client’s year-end is December 31, year 1.
- b. The anticipated audit report date is February 15, year 2.
- c. All amounts are material to the financial statements.

Financial Statement Effect	Audit Response
(1) No impact on financial statement amounts or notes.	(7) Legal response is appropriately dated.
(2) Disclosure in notes relating to nature of litigation, but no amount disclosed.	(8) Update legal response.
(3) Disclosure in notes relating to nature of litigation, including loss amount.	(9) Update audit report date.
(4) Potential litigation settlement accrued in financial statements.	
(5) Potential litigation settlement not accrued in financial statements, amount disclosed in notes.	
(6) Verify amount due attorney is recorded in financial statement amounts.	

Situations	Financial Statement Effect	Audit Response
Letter dated February 14, year 2:		
“I advise you that at and since December 31, year 1, I have not been engaged to give substantive attention to, or represent, XYZ Co. in connection with any pending or threatened litigation, claims, or assessments, nor am I aware of any loss contingencies. No amounts were due to this office for services provided at December 31, year 1.” ⁸	(a)	(b)
Letter dated January 21, year 2:		
“I advise you that at and since December 31, year 1, I have not been engaged to give substantive attention to, or represent, XYZ Co. in connection with any pending or threatened litigation, claims, or assessments, nor am I aware of any loss contingencies. There were fees outstanding of \$3,675 due to this office for services provided at December 31, year 1.” ⁹	(c)	(d)

⁸ Patrick R. Delaney and O. Ray Whittington, *Wiley CPA Exam Review 2011: Auditing and Attestation* (Hoboken, NJ: John Wiley & Sons, October 5, 2010).

⁹ Patrick R. Delaney and O. Ray Whittington, *Wiley CPA Exam Review 2011: Auditing and Attestation* (Hoboken, NJ: John Wiley & Sons, October 5, 2010).

Situations	Financial Statement Effect	Audit Response
Letter dated February 26, year 2:		
<i>K. Bowt v. XYZ Co.:</i> This matter commenced in December, year 1. The plaintiff alleges discrimination relating to his termination on November 17, year 1. The company intends to defend this case vigorously. At this time, we are unable to evaluate the likelihood of an unfavorable outcome or estimate the amount or range of potential loss.	(e)	(f)
Letter dated March 16, year 2:		
<i>J. Myers v. XYZ Co.:</i> This matter commenced in March, year 2. The plaintiff alleges discrimination relating to his termination on November 17, year 1. The company intends to defend this case vigorously. At this time, we are unable to evaluate the likelihood of an unfavorable outcome. The plaintiff is demanding \$50,000.	(g)	(h)
Letter dated February 14, year 2		
<i>R. Brown v. XYZ Co.:</i> This matter commenced in November, year 1. The plaintiff alleges discrimination relating to his termination on March 17, year 1. It is reasonably possible that the case will be settled for approximately \$35,000.	(i)	(j)
Letter dated February 14, year 2		
<i>L. Peep v. XYZ Co.:</i> This matter commenced in November, year 1. The plaintiff alleges discrimination relating to his termination on March 17, year 1. The case is tentatively settled for \$35,000.	(k)	(l)

LO 16-7 16–39. Adapted AICPA Task-Based Simulation

In connection with your audit of the financial statements of Hollis Mfg. Corporation for the year ended December 31, 20X3, your review of subsequent events disclosed the following items:

- January 7, 20X4: The mineral content of a shipment of ore en route to Hollis Mfg. Corporation on December 31, 20X3, was determined to be 72 percent. The shipment was recorded at year-end at an estimated content of 50 percent by a debit to Raw Materials Inventory and a credit to Accounts Payable in the amount of \$82,400. The final liability to the vendor is based on the actual mineral content of the shipment.
- January 15, 20X4: Following a series of personal disagreements between Ray Hollis, the president, and his brother-in-law, the treasurer, the latter resigned, effective immediately, under an agreement whereby the corporation would purchase his 10 percent stock ownership at book value as of December 31, 20X3. Payment is to be made in two equal amounts in cash on April 1 and October 1, 20X4. In December, the treasurer had obtained a divorce from his wife, who is Ray Hollis's sister.
- January 16, 20X4: As a result of reduced sales, production was curtailed in mid-January and some workers were laid off.
- On January 18, 20X4, a major customer filed for bankruptcy. The customer's financial condition had been degenerating over recent years.
- On January 28, 20X4, a famous analyst who followed the industry provided a negative report on his expectations concerning the short and intermediate term for the industry.
 - For each of the subsequent events, indicate whether they should result in:
 - Adjustment—an adjusting entry as of 20X3.
 - Consider Disclosure—consideration of note disclosure as of 20X3.
 - Depending upon the details of the circumstances involved, some of the events may result in neither adjustment nor note disclosure. Select the two events least likely to be reflected (resulting in adjustment or disclosure) in the financial statements.

LO 16-7 16–40. Adapted AICPA Task-Based Simulation

In connection with her audit of the financial statements of Flowmeter Inc. for the year ended December 31, 20X3, Joan Hirsch, CPA, is aware that certain events and transactions that have taken place after December 31, 20X3, but before she has issued her report dated February 28, 20X4, may affect the company's financial statements.

The following material events or transactions have come to her attention:

- a. On January 3, 20X4, Flowmeter Inc. received a shipment of raw materials from Canada. The materials had been ordered in October 20X3 and shipped FOB shipping point in December 20X3.
- b. On January 15, 20X4, the company settled and paid a personal injury claim of a former employee as the result of an accident that had occurred in March 20X3. The company had not previously recorded a liability for the claim.
- c. On January 25, 20X4, the company agreed to purchase for cash the outstanding stock of Porter Electrical Co. The business combination is likely to double the sales volume of Flowmeter, Inc.
- d. On February 1, 20X4, a plant owned by Flowmeter was damaged by a flood, resulting in an uninsured loss of inventory.
- e. On February 5, 20X4, Flowmeter issued to an underwriting syndicate \$2 million in convertible bonds.

For each of the subsequent events, indicate whether they should result in:

Adjustment—an adjusting entry as of 20X3.

Possible Disclosure—Consider note disclosure as of 20X3.

- LO 16-6, 7, 8, 9 16–41.** Match the following terms to the appropriate definition (or partial definition). Each definition is used once.

Term	Definition (or Partial Definition)
a. Commitment	1. A contractual obligation to carry out a transaction at specified terms in the future. Material commitments should be disclosed in the financial statements.
b. Contingent liability	2. A possible liability, stemming from past events, that will be resolved as to existence and amount by some future event.
c. General risk contingency	3. A possible loss, stemming from past events, that will be resolved as to existence and amount by some future event.
d. Iron curtain approach	4. An approach to making materiality judgments that quantifies the total likely misstatement as of the current year-end based on the effects of reflecting all misstatements (including projecting misstatements where appropriate) existing in the balance sheet at the end of the current year, irrespective of whether the misstatements occurred in the current year or previous years.
e. Factual misstatements	5. An approach to making materiality judgments that quantifies the total likely misstatement as of the current year-end based on the effects of reflecting misstatements (including projecting misstatements where appropriate) only during the current year.
f. Projected misstatements	6. An element of the business environment that involves some risk of a future loss. Examples include the risk of accident, strike, price fluctuations, or natural catastrophe. General risk contingencies should not be disclosed in financial statements.
g. Loss contingency	7. Misstatements identified by the auditors during the course of the audit that are due to extrapolation of sample results to the entire population.
h. Rollover approach	8. Misstatements about which there is no doubt as to amount.

16–42. Adapted AICPA Simulation

Note: This simulation integrates concepts first presented in Chapter 5 (see Figure 5.1 for Assertions about Account Balances) and information from throughout the procedural chapters (Chapters 10 through 16) rather than only Chapter 16 coverage. This problem uses only

the four account balances assertions from Figure 5.1; it does not include the cutoff assertion. Accordingly, procedures that might be considered cutoff procedures would generally be considered as addressing either or both of the existence or completeness assertions.

For each of the account balances and associated assertions below, select the audit procedure from the list provided that provides the most appropriate audit evidence for the account assertion.

Account Balances	Assertion	Procedure
1. Accounts receivable	Completeness	a. Review confirmation of accounts receivable balances and agree to accounts receivable subledger. b. Review list of accounts written off during year. c. Review schedule of bad debt expense. d. Trace individual customer account transactions to sales invoice. e. Trace sales invoice and shipping documents just before year-end to customer account transactions.
2. Inventory	Valuation and allocation	a. Examine invoices from suppliers. b. Examine invoices paid subsequent to year-end and trace to subsidiary ledger. c. Select items from inventory listing and locate the items in the warehouse. d. Select items located in the inventory warehouse and trace to inventory listing. e. Trace sales invoices and shipping documents just before year-end to customer accounts.
3. Fixed Assets	Rights and Obligations	a. Interview plant manager regarding fixed asset additions during the year. b. Recalculate partial year depreciation for fixed asset acquisitions. c. Trace fixed asset item to fixed asset master control listing. d. Vouch fixed asset acquisitions to purchase invoices. e. Vouch fixed asset acquisitions to related cash disbursement.
4. Accounts payable	Completeness	a. Compare aging of accounts payable to prior periods. b. Confirm accounts payable balance with suppliers. c. Examine invoices paid subsequent to year-end and trace to subsidiary ledger. d. Trace individual payable transaction to purchase order. e. Vouch invoices for the purchase of supplies to receiving documents.
5. Cash	Existence	a. Agree bank statement to the subsidiary ledger. b. Agree cash balance per the bank reconciliation to the year-end bank statement. c. Agree cash balance to online year-end bank statement. d. Recalculate bank statement balance including interest receivable. e. Trace deposit per the bank statement to the cash subsidiary ledger.

Problems

LO 16-1, 3

- 16–43. Rita King, your staff assistant on the April 30, 20X2, audit of Maxwell Company, was transferred to another assignment before she could prepare a proposed adjusting journal entry for Maxwell's Miscellaneous Revenue account, which she had analyzed per the working paper given below. You have reviewed the working paper and are satisfied with King's procedures. You are convinced that all the miscellaneous revenue items should be transferred to other accounts. Maxwell Company's state of incorporation has an Unclaimed Properties Law.

Draft a proposed adjusting journal entry at April 30, 20X2, for Maxwell Company's Miscellaneous Revenue account.

Maxwell Company Miscellaneous Revenue Year Ended April 30, 20X2				Q-2
Acct. No. 430				
		C.M. May 19, X2		
Date	Description	Reference	Amount	
May 8, 20X1, through April 7, 20X2	Proceeds of sale of scrap from manufacturing process (total of 12 monthly sales)	Various CR	\$5,843	Y
July 18, 20X1	Write-off of old outstanding checks; nos. 118—\$500; 214—\$400; 407—\$200	GJ 7-4	1,100	Y
Sept. 22, 20X1	Recovery of previously written off account receivable from Wilson Company	CR 9-1	4,381	Y
Feb. 6, 20X2	Cash proceeds from sale of machine. Cost of \$10,000 and accumulated depreciation of \$8,000 as of Feb. 6, X2, not removed from accounts	CR 2-1	3,500	Y
April 28, 20X2	Refund of premium overcharge on fire insurance policy no. 1856, for period April 1, 20X2-Mar. 31, 20X3	CR 4-1	600	Y
April 30, 20X2	Balance per ledger		<u>\$15,424</u>	
Y—Traced to cash receipts journal or general journal; vouched to appropriate supporting documents.				
				R.A.K. May 18, X2

- LO 16-1, 2, 3 16–44. Your client is a company that owns a shopping center with 30 store tenants. All leases with the store tenants provide for a fixed rent plus a percentage of sales, net of sales taxes, in excess of a fixed dollar amount computed on an annual basis. Each lease also provides that the lessor may engage CPAs to audit all records of the tenant for assurance that sales are being properly reported to the lessor.

You have been requested by your client to audit the records of Traders Restaurant to determine that the sales totaling \$390,000 for the year ended December 31, 20X2, have been properly reported to the lessor. The restaurant and the shopping center entered into a five-year lease on January 1, 20X1. Traders Restaurant offers only table service; no liquor is served. During mealtimes, there are four or five servers in attendance who prepare handwritten prenumbered restaurant checks for the customers. Payment is made at a cash register, operated by the proprietor, as the customer leaves. All sales are for cash. The proprietor also is the accountant. Complete files are kept of restaurant checks and cash register tapes. A daily sales journal and general ledger are also maintained.

List the auditing procedures that you would employ to verify the total annual sales of Traders Restaurant.

- LO 16-4, 5** 16-45. The following are typical questions that might appear on an internal control questionnaire for payroll activities:
1. Is there adequate separation of duties between employees who maintain human resources records and employees who approve payroll disbursements?
 2. Is there adequate separation of duties between personnel who maintain timekeeping or attendance records for employees and employees who distribute payroll checks?
 - a. Describe the purpose of each of the above controls.
 - b. Describe the manner in which each of the above controls might be tested.
 - c. Assuming that the operating effectiveness of each of the above controls is found to be inadequate, describe how the auditors might alter their substantive procedures to compensate for the increased level of control risk.

- LO 16-4, 5** 16-46. In connection with an audit of the financial statements of Olympia Company, the auditors are reviewing procedures for accumulating direct labor-hours. They learn that all production is by job order and that all employees are paid hourly wages, with time and a half for overtime hours.

Olympia's direct labor-hour input process for payroll and job-cost determination is summarized in the flowchart that is illustrated next. Steps A and C are performed in timekeeping, step B in the factory operating departments, step D in payroll audit and control, step E in data input, and step F in computer operations.

For each input processing step A through F:

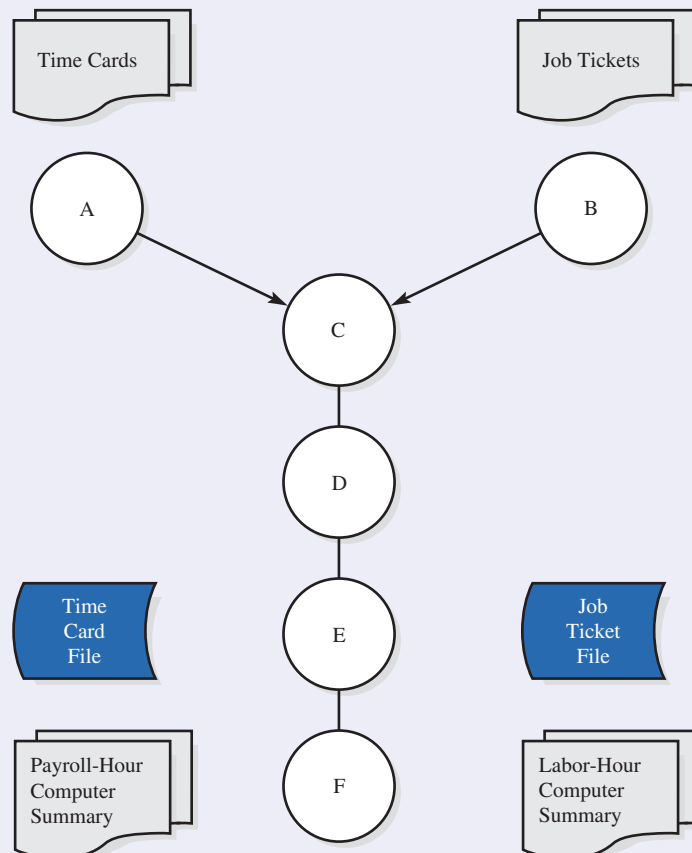
- a. List the possible errors or discrepancies that may occur.
- b. Cite the corresponding control that should be in effect for each error or discrepancy.

Note: Your discussion of Olympia's procedures should be limited to the input for direct labor-hours, as shown in steps A through F in the flowchart. Do not discuss human resources procedures for hiring, promotion, termination, and pay-rate authorization. In step F, do not discuss equipment, computer program, and general computer controls.

Organize your answer for each input-processing step as follows:

Step	Possible Misstatements or Discrepancies	Control
A		

Source: (AICPA, adapted)



- LO 16-4** 16-47. Rowe Manufacturing Company has about 50 production employees and uses the following payroll procedures.

The factory supervisor interviews applicants and on the basis of the interview either hires or rejects the applicants. After being employed, the applicant prepares a W-4 form (Employee's Withholding Exemption Certificate) and gives it to the supervisor. The supervisor writes the hourly rate of pay for the new employee in the corner of the W-4 form and then gives the form to a payroll clerk as notice that the applicant has been employed. The supervisor verbally advises the payroll department of pay-rate adjustments.

A supply of blank time cards is kept in a box near the entrance to the factory. Each employee takes a time card on Monday morning, signs it, and notes in pencil on the time card the daily arrival and departure times. At the end of the week, the employees drop the time cards in a box near the door to the factory.

The completed time cards are taken from the box on Monday morning by a payroll clerk. Two payroll clerks divide the cards alphabetically between them, one taking the A–L section of the payroll and the other taking the M–Z section. Each clerk is fully responsible for one section of the payroll. The payroll clerks compute the gross pay, deductions, and net pay; post the details to the employees' earnings records; and prepare and number the payroll checks. Employees are automatically removed from the payroll when they fail to turn in time cards.

The payroll checks are manually signed by the chief accountant and given to the supervisor, who distributes the checks to the employees in the factory and arranges for the delivery of the checks to the employees who are absent. The payroll bank account is reconciled by the chief accountant, who also prepares the various quarterly and annual payroll tax reports.

List your suggestions for improving Rowe Manufacturing Company's internal control over factory hiring practices and payroll.

- LO 16-7** 16-48. Robertson Company had accounts receivable of \$200,000 at December 31, 20X0, and had provided an allowance for uncollectible accounts of \$6,000. After performing all normal auditing procedures relating to the receivables and to the valuation allowance, the independent auditors were satisfied that this asset was fairly stated and that the allowance for uncollectible accounts was adequate. Just before completion of the audit fieldwork late in February, however, the auditors learned that the entire plant of Thompson Corporation, a major customer, had been destroyed by a flood early in February and that, as a result, Thompson Corporation was hopelessly insolvent.

The account receivable from Thompson Corporation in the amount of \$44,000 originated on December 28; terms of payment were net 60 days. The receivable had been regarded as entirely collectible at December 31, and the auditors had so considered it in reaching their conclusion as to the adequacy of the allowance for uncollectible accounts. In discussing the news concerning the flood, the controller of Robertson Company emphasized to the auditors that the probable loss of \$44,000 should be regarded as a loss of the following year, and not of 20X0, the year under audit.

What action, if any, should the auditors recommend with respect to the receivable from Thompson Corporation?

In-Class Team Case

LO 16-8



- 16-49. The audit staff of Adams, Barnes & Co. (ABC), CPAs, reported the following audit findings in their 20X5 audit of Keystone Computers & Networks (KCN) Inc.:

1. Unrecorded liabilities in the amount of \$6,440 for purchases of inventory. These inventory items were counted and included in the year-end total.
2. Projected misstatement from confirmation of accounts receivable in the amount of \$2,042 understatement.
3. Projected misstatement from price tests of inventory of \$9,510 overstatement.
4. The staff of ABC believes that the amount of KCN's allowance for uncollectible accounts should be increased by \$5,000.

In addition, the audit staff has decided that for evaluating a material misstatement of the financial statements, the following guidelines should be used:

Current assets—\$50,000

Noncurrent assets—\$75,000

Current liabilities—\$50,000

Noncurrent liabilities—\$75,000

Net income before taxes—\$65,000

- a. Prepare a schedule modeled after Figure 16.4 to be used to evaluate the above audit findings, assuming that KCN's marginal tax rate is 25 percent.
- b. Decide whether the results indicate that there is a sufficiently low risk of material misstatement to justify ABC's audit opinion.

Research and Discussion Case

LO 16-6, 8



- 16-50. Marshall and Wyatt, CPAs, has been the independent auditor of Interstate Land Development Corporation for several years. During these years, Interstate prepared and filed its own annual income tax returns.

During 20X4, Interstate requested Marshall and Wyatt to audit all the necessary financial statements of the corporation to be submitted to the Securities and Exchange Commission (SEC) in connection with a multistate public offering of 1 million shares of Interstate common stock.

This public offering came under the provisions of the Securities Act of 1933. The audit was performed carefully and the financial statements were fairly presented for the respective periods. These financial statements were included in the registration statement filed with the SEC.

While the registration statement was being processed by the SEC, but before the effective date, the Internal Revenue Service (IRS) obtained a federal court subpoena directing Marshall and Wyatt to turn over all its working papers relating to Interstate for the years 20X1–20X4. Marshall and Wyatt initially refused to comply for two reasons. First, Marshall and Wyatt did not prepare Interstate's tax returns. Second, Marshall and Wyatt claimed that the working papers were confidential matters subject to the privileged communications rule. Subsequently, however, Marshall and Wyatt did relinquish the subpoenaed working papers.

Upon receiving the subpoena, Wyatt called Dunkirk, the chair of Interstate's board of directors, and asked him about the IRS investigation. Dunkirk responded, "I'm sure the IRS people are on a fishing expedition and that they will not find any material deficiencies."

A few days later, Dunkirk received a written memorandum from the IRS stating that it was contending Interstate had underpaid its taxes during the period under review. The memorandum revealed that Interstate was being assessed \$800,000, including penalties and interest for the three years. Dunkirk forwarded a copy of this memorandum to Marshall and Wyatt. This \$800,000 assessment was material relative to the financial statements as of December 31, 20X4. The amount for each year individually, exclusive of penalty and interest, was not material relative to each respective year.

- a. In general terms, discuss the extent to which a CPA firm's potential liability to third parties is increased in an SEC registration audit.
- b. Discuss the implications of the IRS investigation, if any, relative to Marshall and Wyatt's examination of Interstate's 20X4 financial statements. Discuss any additional investigative procedures that the auditors should undertake or any audit judgments that should be made as a result of this investigation.
- c. Can Marshall and Wyatt validly refuse to surrender the subpoenaed working papers to the IRS? Explain.

Source: (AICPA, adapted)

Supplementary References

Part a:

Chapter 4, Liability to Third Parties under Statutory Law.

Part b:

Chapter 16, Perform the Review for Subsequent Events.

AICPA, Professional Standards, *Statements on Auditing Standards*, AU-C section 560. FASB *Accounting Standard Codification* section 450-20, "Loss Contingencies."

Part c:

Chapter 3, Confidential Client Information Rule, and Chapter 5, Confidential Nature of Working Papers.

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Auditors' Reports

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 17-1** Describe the audit report with an unmodified opinion for nonpublic entity (nonissuer) audits.
- LO 17-2** Describe the audit report with an unqualified opinion for public entity (issuer) audits.
- LO 17-3** Identify the circumstances that result in audit reports with unmodified opinions with additional financial statement-related information included.
- LO 17-4** Identify the circumstances that result in audit reports with modified audit opinions.
- LO 17-5** Describe the auditors' responsibilities for reporting on comparative financial statements.

Expressing an independent and expert opinion on the fairness of financial statements is the most frequently performed attestation service rendered by the public accounting profession. This opinion, which is expressed in the auditors' report, indicates to users of financial statements whether the auditors believe that the statements are in conformity with the appropriate financial reporting framework, most frequently generally accepted accounting principles.

In Chapter 2, we saw that audit reports with an unmodified opinion for nonpublic companies state that the audit was performed in accordance with AICPA generally accepted auditing standards, while audit reports for public companies refer to PCAOB standards. Both reports are modified if

- There are conditions, although not departures from GAAP, about which the readers of the financial statements should be informed (e.g., a lack of consistent application of GAAP).
- There are material departures from GAAP in the client's financial statements.
- The auditors are unable to obtain sufficient appropriate audit evidence (e.g., due to client not retaining certain essential records).

In this chapter, we describe the types of audit reports that auditors issue in various circumstances. Their goal in reporting is to present clearly the nature of the audit and their opinion on the financial statements.

Financial Statements and Audit Reports with Unmodified (Unqualified) Opinions

Because we are discussing audit reports that relate to financial statements, we first briefly provide an overview of financial statements, including disclosures. Next, we discuss in detail the unmodified audit reports included in professional standards issued by the AICPA Auditing Standards Board (for nonpublic clients) and by the Public Company Accounting Oversight Board (for public clients). Hereafter, we will often refer to these reports and reporting requirements simply as nonpublic and public company audit reports and requirements, rather than using the longer terms.

Financial Statements

Auditors most frequently report upon a complete set of financial statements: that is, the balance sheet, the income statement, the statement of retained earnings, the statement of cash flows, and the related notes.¹ In some cases, the statement of retained earnings is either expanded to

¹ As is discussed in further detail in Chapter 19, auditors may report on less than the complete set of financial statements. For example, the auditors could issue an audit report with an opinion on a balance sheet alone. One issue that complicates matters is a GAAP requirement that when a company presents a balance sheet and an income statement, it also must present a statement of cash flows; if a statement of cash flows is omitted in this situation, a departure from GAAP exists.

a statement of stockholders' equity or combined with the income statement. Financial statements generally are presented in comparative form for the current year and one or more preceding years. The financial statements for a parent corporation usually are consolidated with those of the subsidiaries. In the United States, these financial statements are most frequently prepared following the **general-purpose financial reporting framework** referred to as *accounting principles generally accepted in the United States of America*. This chapter emphasizes audit reports based on financial statements prepared following these principles. Chapter 19 describes reporting on financial statements prepared following other frameworks (e.g., cash basis and tax basis).

Financial Statement Disclosures

The purpose of notes to financial statements is to properly disclose information required by generally accepted accounting principles that cannot be adequately conveyed on the face of the financial statements. Adequate disclosure in the notes to the financial statements is necessary for the auditors to issue an unmodified opinion on the financial statements.

The Financial Accounting Standards Board (FASB), the Government Accounting Standards Board (GASB), the Federal Accounting Standards Advisory Board (FASAB), and the Securities and Exchange Commission (SEC) have issued numerous pronouncements that have added extensive disclosure requirements. Examples of these requirements include the disclosure of significant accounting policies, accounting changes, loss contingencies, and lease and postretirement benefit information.

In evaluating financial reporting disclosures, the auditors should keep in mind that disclosures are meant to *supplement* the information on the face of the financial statements—not to *correct* improper financial statement presentation. Thus, a note or supplementary schedule, no matter how skillfully drafted, does not compensate for the erroneous presentation of an item on the face of the financial statements.

Comparative Financial Statements

Comparative financial statements are financial statements for one or more prior periods, included for comparison with the financial statements of the current period. Comparative financial statements allow users to identify changes and trends in the financial position and operating results of a company over an extended period, and thus are more useful to investors and creditors than are financial statements for a single period. Publicly owned companies are required to include in their annual reports the balance sheets for each of the last two years and the related statements of income, retained earnings, and cash flows for each of the last three years. The auditors' report covers all financial statements that are presented. Later in this chapter, we will describe in detail the auditors' reporting responsibilities when management presents comparative financial statements.

Audit Reports with Unmodified Opinions—Nonpublic Clients

Chapter 2 includes an unmodified report on the audit of a nonpublic company's financial statements for two years. The following is a nonpublic company unmodified report² on financial statements for one year (AICPA AU-C 700):

² Historically, auditing standards have referred to this type of report—one with an unmodified opinion and no additional information presented beyond that here illustrated—as a “**standard report**.” Although in practice the term is sometimes still used, neither current nonpublic nor public company standards currently use the term.

LO 17-1

Describe the audit report with an unmodified opinion for nonpublic entity (nonissuer) audits.

Independent Auditor's Report

To the Shareholders and Board of Directors of ABC Company
17 East Main, Phoenix AZ 85011

Opinion

We have audited the financial statements of ABC Company, which comprise the balance sheet as of December 31, 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Basis for Opinion

We conducted our audit in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of ABC Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audit. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company's ability to continue as a going concern for one year subsequent to issuance of these financial statements.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered to be material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgment made by a reasonable user based on the financial statements.

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances*, but not for the purpose of expressing an opinion on the effectiveness of ABC Company's internal control. Accordingly, no such opinion is expressed.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control-related matters that we identified during the audit.

Williams & Co., LLP

Phoenix, Arizona
February 5, 20X2

*Section (bullet) ends at this point when auditors also are expressing an opinion on the effectiveness of internal control.

The report should have a title that includes the word *independent*. It is addressed to those for whom it is prepared (ordinarily some combination of the shareholders, board of directors, the audit committee, or the company itself). The city and state used is ordinarily the address included in the engagement letter. Also, when the client is different from the entity for which the audit is being performed (e.g., Jones, Inc. hires the auditors to audit Company B's financial statements), the addressee and address may be that of the client (i.e., Jones, Inc.).

The report is divided into a number of sections with headings (here sections on the auditors' opinion, basis for opinion, and management and auditors' responsibilities). Each section is composed of one or more paragraphs. For example, in this type of report, the Basis for Opinion section includes that heading and one paragraph. We use the terms "heading" and "title" interchangeably. The AICPA Auditing Standards Board uses "heading," whereas the PCAOB uses the term "title."³

The first section of the report is the Opinion section. Its first paragraph indicates that an audit of the financial statements has been performed and it is followed by a paragraph that provides an opinion on whether the financial statements are presented in conformity with generally accepted accounting principles. The next section, the Basis for Opinion section, indicates that the audit was conducted in accordance with GAAS, and the auditors are independent. It also states that they have followed the relevant ethical responsibilities, and believe that they have obtained sufficient appropriate audit evidence.

With the exception of the Opinion section being the first section and the Basis for Opinion section the second, the standards do not specify the order of the remaining sections of the auditors' report. Placement of subsequent sections depends upon the auditors' judgment about the relative significance of such information to intended users. In the report illustrated in the auditing standards, the sections on management and auditors' responsibilities are presented next, in that order.

Historically, audit reports issued in the United States referred simply to generally accepted auditing standards and generally accepted accounting principles. Today, however, a number of nations have their own generally accepted standards (principles), and those standards generally differ from one another. To reduce confusion, nonpublic company audit reports issued in the United States now use terms such as "generally accepted auditing standards (United States of America)" or "auditing standards generally accepted in the United States of America." A similar modification is made relating to generally accepted accounting principles. For simplicity's sake, in our text discussion, we often will use the simpler historical terms or their abbreviations "GAAP" and "GAAS."⁴

The nonpublic company audit report is signed with the name of the CPA firm, not the name of an individual partner in the firm (if they differ). However, if the CPA is practicing under their own name as a sole practitioner, the report is signed with the CPA's personal name. In addition, a sole practitioner should use *I* instead of *we* in the audit report.

Also notice the date following the signature. The auditors' report should not be dated earlier than the date on which the auditors have obtained sufficient appropriate audit evidence to support their opinion on the financial statements. Sufficient appropriate audit

³ Both the nonpublic and public auditing standards sometimes speak of including a "paragraph with a title" or a "section." We will consider these synonymous—a paragraph with a title is a section. When the standards speak of adding a paragraph *without a title*, no section is created as the paragraph is added to an existing section. Also, while the standards speak of adding a *paragraph* (with or without a title), in practice often more than one paragraph is included to describe the matter. Throughout this chapter we capitalize specific section titles.

⁴ While a nonpublic company audit will be performed following GAAS, a client may ask the auditors also to conduct the audit following another set of auditing standards in addition to GAAS. For example, a company may be considering becoming public and request an audit in accordance with both GAAS and PCAOB standards. In such a situation, the auditor may perform such an audit and the audit report should indicate that the audit was conducted in accordance with both sets of standards. When the other standards are those of the PCAOB, the form of the report should be that of the PCAOB, as modified to indicate that GAAS also were followed.

evidence has been obtained when all audit documentation has been reviewed, the financial statements (including notes) are prepared, and management has asserted that it takes responsibility for these financial statements (ordinarily through a representation letter). The date of the audit report is quite significant because the auditors have a responsibility through that date to perform procedures to search for any subsequent events that may affect the fairness of the client's financial statements (see Chapter 16). Also, there are specific requirements relating to changes in documentation that arise after that date (see Chapter 5).⁵

An auditors' report with an unmodified opinion may be issued only when the auditors have obtained sufficient appropriate audit evidence to conclude that the financial statements, as a whole, are not materially misstated.

Other Information

When a nonpublic client's financial statements are presented as a part of an annual report that includes **other information** in addition to the financial statements (e.g., a management report, corporate governance statement, financial summaries), the audit report includes an Other Information section such as the following:

Other Information

Management is responsible for the other information included in the annual report. The other information comprises the [provide titles of information included in the annual report], but does not include the financial statements and our auditor's report thereon. Our opinion on the financial statements does not cover the other information and we do not express an opinion or any form of assurance thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and consider whether a material inconsistency exists between the other information and the financial statements or the other information otherwise appears to be materially misstated. If, based on the work performed, we conclude that an uncorrected material misstatement of the other information exists, we are required to describe it in our report.

This section follows at an appropriate point after the Basis for Opinion section. Other Information is discussed further in Chapter 16.

Key Audit Matters

In the audit reports for nonpublic companies, the auditors may agree to disclose the **key audit matters (KAMs)** encountered in the audit. Key audit matters are defined as

Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated to those charged with governance.

Reporting of KAMs is not required by nonpublic company auditing standards. They are included in the auditors' report based on the client's desire for their disclosure or when inclusion is required by law or regulation. When included, the audit report ordinarily only presents current period KAMs and not those of any other years of financial statements being presented.

⁵ Auditors sometimes have reporting responsibilities related to other legal and regulatory requirements. For example, for audits performed under Government Auditing Standards, the auditors may be required to report on internal control over financial reporting and on compliance with laws, regulations, and other matters. It is when the relevant law or regulation requires or permits the auditors to report within the auditors' report on the financial statements that this becomes relevant. In such a situation, the overall report is divided as described below:

- *Report on Financial Statements.* This heading is added above the Opinion section.
- *Report on Other Legal and Regulatory Requirements.* This heading and the related report follow the final section on the financial statements (Auditor's Responsibilities for the Audit of the Financial Statement section in the AICPA ASB illustrations).

The following is an example of a section of the auditors' report that discloses KAMs:

Key Audit Matters

Key audit matters are those matters that were communicated with those charged with governance and, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter]

The Key Audit Matters section of the audit report follows at an appropriate point after the Basis for Opinion section.

The Nature of Key Audit Matters

Throughout this text we have pointed out that the audit of certain areas of the financial statements may be particularly challenging. For example, as discussed in Chapter 5, obtaining audit evidence about appropriate valuation when subjective accounting estimates must be used (e.g., the valuation of complex financial instruments) may be particularly complex and difficult.

Notice that the definition of KAMs includes a requirement that the matters have been communicated or are required to be communicated to those charged with governance (ordinarily, the audit committee). While Chapter 16 discusses matters communicated to the audit committee in detail, AICPA standards require communication of financial statement–related matters such as significant risks, significant unusual transactions, certain related party transactions, and other matters significant to oversight of the company. In identifying KAMs, the auditors select from the matters communicated to those charged with governance those that required significant audit attention. In making this determination, AU-C 701 states that the auditors should consider the following:

- Areas of higher assessed risk of material misstatement, or **significant risks** identified.
- Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.
- The effect on the audit of significant events or transactions that occurred during the period.

Recall that a significant risk is an identified and assessed risk of material misstatement that, in the auditors' judgment, requires special audit consideration—this concept is discussed in Chapter 6. While significant risks may well be considered KAMs, not all are. For example, while the risk of revenue recognition fraud is presumed to be a significant risk on all audits, for a particular audit it may not involve significant auditor judgment and thus not be considered a KAM.

For matters determined to be KAMs, the auditors should describe the matter, including why it was considered a key audit matter, and how the matter was addressed in the audit. The description of how it was addressed includes some combination of (1) the auditors' response or approach to the matter, (2) a brief overview of procedures performed, (3) an indication of the outcome of the audit procedures, and (4) key observations on the matter.

Because public company audit reports include a similar concept (**critical audit matters**), we provide a comparison of the two concepts later in this chapter.

Audit Reports with Unqualified Opinions—Public Clients

LO 17-2

Describe the audit report with an unqualified opinion for public entity (issuer) audits.

The following is an example of an audit report with an unqualified opinion based on the audit of a public company

Report of Independent Registered Public Accounting Firm

To the Shareholders and the Board of Directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the “Company”) as of December 31, 20X7 and 20X6, the related statements of income, comprehensive income, stockholders’ equity, and cash flows, for each of the three years in the period ended December 31, 20X7, and the related notes [and schedules] (collectively referred to as the “financial statements”). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 20X7 and 20X6, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X7, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with standards of the Public Company Accounting Oversight Board (United States) (“PCAOB”) the Company’s internal control over financial reporting as of December 31, 20X7, based on *Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)* and our report dated February 9, 20X8, expressed an unqualified opinion.

Basis for Opinion

These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on the Company’s financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matters

The critical audit matters communicated below are matters arising from the current period audit of the financial statements that were communicated or required to be communicated to the audit committee and that (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

[Include critical audit matters]

Blue, Gray & Company
Certified Public Accountants

We have served as the Company’s auditor since 20X0.
Los Angeles, California
February 8, 20X8

The title of the report must include the words “Report of Independent Registered Public Accounting Firm.” It must be addressed to the shareholders and the board of directors (or equivalents for companies not organized as corporations), although additional addressees may be added. As is the case with nonpublic company audit reports, the first two sections of the report are the Opinion and Basis for Opinion sections, in that order. When management has issued a report on internal control, but the auditors have only

audited the financial statements, which generally occurs for companies with a market capitalization of less than \$75,000,000 or revenues less than \$100 million in the preceding year, the second paragraph in the Opinion section is deleted. Also, the following is added after the second sentence of the second paragraph of the Basis for Opinion section:

The company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. As part of our audits we are required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.

As is detailed further below, most PCAOB audit reports also include a Critical Audit Matters section.

The report is concluded with the CPA firm's signature, its city and state, and the audit report date. In addition, a public company report indicates when the firm began serving the company as its auditors (referred to as firm "tenure"). The tenure date is defined as the earlier of when the CPA firm signed its first engagement letter with the client or when it first began performing audit procedures for the client.

The report may also include an engagement partner disclosure section, which includes the name of the engagement partner. For example:

Engagement Partner Disclosure

The engagement partner on our audit for the year ended December 31, 20XX, was Janet Louise Williams.

Such a section is not frequently included in the audit report. As discussed later in this chapter, the name of the engagement partner is required to be disclosed in PCAOB Form AP.

Critical Audit Matters

As indicated above, most public company audit reports are required to include disclosure of **critical audit matters (CAMs)**,⁶ which the PCAOB defines as

Any matters arising from the audit that were communicated or required to be communicated to the audit committee and that (1) relate to accounts or disclosures that are material to the financial statements, and (2) involved especially challenging, subjective, or complex auditor judgment.

Critical audit matters for public companies are similar to the key audit matters that may be disclosed in audit reports for nonpublic companies.

A CAM must be related to a material financial statement account or disclosure and involve "especially challenging, subjective, or complex auditor judgment." In identifying CAMs, the auditors should consider factors such as the

- Assessment of the risks of material misstatement, including significant risks.
- Degree of auditor judgment related to financial statement areas that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty.
- Nature and timing of significant unusual transactions and the extent of audit effort and judgment related to them.
- Nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of needed consultations outside the engagement team.
- Nature of audit evidence obtained regarding the matter.

⁶ There are several exclusions to the requirement of including critical audit matters in audit reports. In general, audit reports of (1) brokers and dealers, (2) investment companies, (3) benefit plans, and (4) emerging growth companies do not require such a section. Also, as indicated later in this chapter, audit reports with adverse opinions and disclaimers of opinion do not include a section on CAMs.

For each CAM that is disclosed, the auditors must include the following information in the audit report:

- Identification of the matter.
- Description of the principal considerations that led the auditors to determine that the matter is a CAM.
- Description of how the CAM was addressed in the audit.
- Reference to the relevant financial statement accounts and disclosures that relate to the CAM.

The description of how it was addressed (the third bullet) includes some combination of (1) the auditor's response or approach to the matter, (2) a brief overview of procedures performed, (3) an indication of the outcome of the audit procedures, and (4) key observations on the matter. In describing a CAM, the auditors are not ordinarily expected to provide information about that company that has not been made publicly available by the company unless that information is necessary to describe the principal consideration that led the auditors to determine that the matter is a CAM.

The PCAOB requires the auditors to include CAMs only for the current audit period, not all periods for which financial statements are presented. However, auditors also may choose to communicate CAMs of prior periods that are presented. For example, when the prior year financial statements are being made public for the first time, the auditors may choose to also communicate the prior year CAMs.

Illustrative Case: Example of a Critical Audit Matter (CAM)

The following critical audit matter was included in Deloitte and Touche's 2023 audit report on Microsoft Corporation.

Critical Audit Matter Description

The Company's long-term income taxes liability includes uncertain tax positions related to transfer pricing issues that remain unresolved with the Internal Revenue Service ("IRS"). The Company remains under IRS audit, or subject to IRS audit, for tax years subsequent to 2003. While the Company has settled a portion of the IRS audits, resolution of the remaining matters could have a material impact on the Company's financial statements.

Conclusions on recognizing and measuring uncertain tax positions involve significant estimates and management judgment and include complex considerations of the Internal Revenue Code, related regulations, tax case laws, and prior-year audit settlements. Given the complexity and the subjective nature of the transfer pricing issues that remain unresolved with the IRS, evaluating management's estimates relating to their determination of uncertain tax positions required extensive audit effort and a high degree of auditor judgment, including involvement of our tax specialists.

How the Critical Audit Matter Was Addressed in the Audit

Our principal audit procedures to evaluate management's estimates of uncertain tax positions related to unresolved transfer pricing issues included the following:

- We evaluated the appropriateness and consistency of management's methods and assumptions used in the identification, recognition, measurement, and disclosure of uncertain tax positions, which included testing the effectiveness of the related internal controls.
- We read and evaluated management's documentation, including relevant accounting policies and information obtained by management from outside tax specialists, that detailed the basis of the uncertain tax positions.
- We tested the reasonableness of management's judgments regarding the future resolution of the uncertain tax positions, including an evaluation of the technical merits of the uncertain tax positions.
- For those uncertain tax positions that had not been effectively settled, we evaluated whether management had appropriately considered new information that could significantly change the recognition, measurement, or disclosure of the uncertain tax positions.
- We evaluated the reasonableness of management's estimates by considering how tax law, including statutes, regulations, and case law, impacted management's judgments.

The entire audit report (which also includes a CAM on revenue recognition) is included in Microsoft Corporation's 2023 Form 10-K available on the SEC's EDGAR system (www.sec.gov/edgar).

PCAOB auditing standards include the following examples to assist auditors in identifying CAMs:

- A potential loss contingency for which management recorded an accrual and/or made a disclosure could potentially be a CAM. However, a potential loss contingency for which the likelihood was appropriately determined to be remote, and which was not recorded in the financial statements, or otherwise disclosed, would not be a CAM because it would not relate to an account or disclosure that is material to the financial statements.
- A potential illegal act about which management provided disclosure could be determined to be a CAM. Even if the amounts involved were not quantitatively material, such disclosure on its own may be qualitatively material. On the other hand, if management appropriately determined that no disclosure or accrual was required in the financial statements, the matter would not be a CAM.

In some situations a significant deficiency or material weakness in internal control may be identified as a CAM. However, the severity of the deficiency does not in and of itself determine whether it is a CAM. To be identified as a CAM, the deficiency must affect one or more material financial statement accounts or disclosures that required especially challenging, subjective, or complex auditor judgment.

A question that arises is whether a prior-year CAM should again be included in the audit report. If the CAM continued to require challenging, subjective, or complex auditor judgment, it should again be included. However, if it does not, it should not be included in the current-year report. An example of this latter situation is implementation of a new accounting standard for accounting for a significant unusual transaction, which may require such judgment only in the year in which it occurs, but not thereafter.

Finally, in situations in which the auditors determine that there are no critical audit matters on an audit, a paragraph is included in the report defining a critical matter and then indicating that there were none identified.

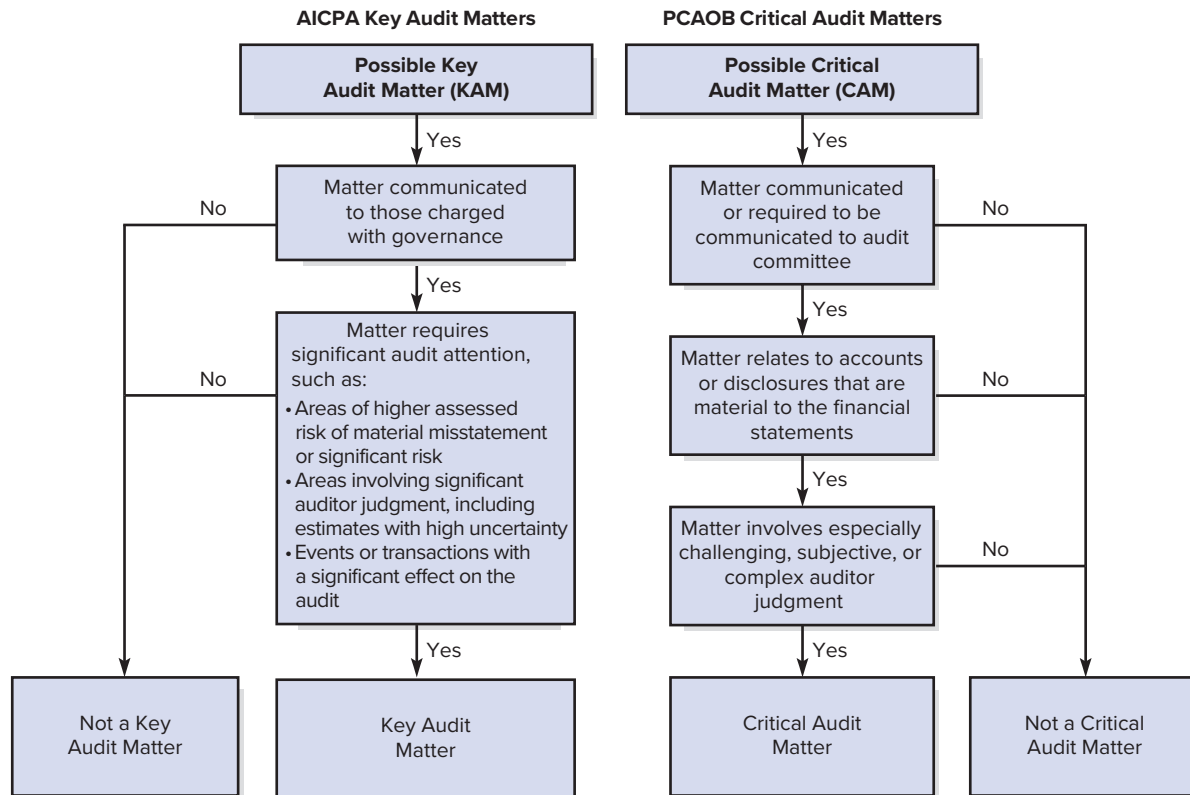
Additional Guidance on Key Audit Matters and Critical Audit Matters

What types of matters are included in the KAM and CAM concepts? Although company- and audit-specific considerations affect which items are identified as CAMs or KAMs, subjective audit areas such as the following will often merit consideration:

- The allowance for sales returns.
- Loan loss provisions.
- Goodwill impairment.
- Accounting for acquisitions.
- Going concern assessments.
- Hard-to-value financial instruments.
- Income taxes.

While the concepts of CAMs and KAMs are similar, they are not identical. Figure 17.1 highlights the differences between the concepts, including

- Notice in Figure 17.1 that both KAMs and CAMs are selected from among the matters communicated to those charged with governance (ordinarily the audit committee for public companies). While those communications are very similar for public and nonpublic companies, differences in wording between AICPA Auditing Standards Board and PCAOB standards may create situations in which the matters communicated are not identical.
- The differing definitions of KAMs and CAMs conceptually make possible the identification of different items. For example, while the primary focus of KAMs is on matters of most significance during the audit, the definition of CAMs focuses on matters involving especially challenging, subjective, or complex auditor judgment related to *material* financial statement accounts and disclosures. This difference could, in concept, result in different matters being identified. As an example, the implementation of

FIGURE 17.1 Identifying Key and Critical Audit Matters

a new information system might in and of itself qualify as a KAM. However, it would qualify as a CAM only if it is considered to be related to material accounts or disclosures. However, the interpretational guidance in the AICPA auditing standards does emphasize the effect on accounts and disclosures.

Figure 17.2 summarizes major concepts and requirements related to the two concepts. Notice that they are not included in reports with adverse opinions or disclaimers of opinions.

Additional Information Disclosed in PCAOB Form AP

PCAOB Form AP is a form that must be filed with the PCAOB within 35 days of the date the audit report is first included in a document filed with the Securities and Exchange Commission; this period is shortened to 10 days for registration statements for new issuances of securities. In addition to requiring the engagement partner's name, the form requires disclosure of the total audit hours spent on the financial statement audit, reviews of interim financial statements, and the audit of internal control over financial reporting. When other accounting firms participated in the audit, the following information also is required:

- Name, location, and extent of participation of each other accounting firm whose work constituted at least 5 percent of total audit hours.
- Number and aggregate extent of participation of all other accounting firms whose work was less than 5 percent of total audit hours.

While Form AP is designed in part to disclose the engagement partner's name, as illustrated earlier, the PCAOB allows, but does not require, disclosure of that individual's name in the PCAOB audit report. International auditing standards require disclosure of the name of the engagement partner for public company audits in the audit report itself.

FIGURE 17.2 Overview of Key and Critical Audit Matters

	AICPA ASB Key Audit Matters (nonpublic company audit reports)	PCAOB Critical Audit Matters (public company audit reports)
Definition	Those matters that, in the auditors' professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated to those charged with governance.	Matters arising from the audit of the financial statements that were communicated or required to be communicated to the audit committee and that (1) relate to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment.
Limited to matters communicated or required to be communicated to those charged with governance?	Yes.	Yes.
Key requirements in addition to communication to those charged with governance (definition, plus summary from professional standards for key audit matters).	Matters of most significance to audit; auditors should take into account: • Areas of higher assessed risk of material misstatement or identified significant risks. • Significant auditor judgments relating to financial statement areas that involved significant management judgment, including accounting estimates with high estimation uncertainty. • Effect on the audit of significant events or transactions that occurred during the period.	Matters involving especially challenging, subjective, or complex auditor judgment related to material financial statement accounts or disclosures.
Required in audit reports?	No, not in general. But the auditors may be required to communicate by the terms of the engagement (by either client choice, law, or regulation).	Yes, for most public companies. Certain companies are excluded (e.g., broker dealers, investment funds, benefit plans).
Years of KAMs (CAMs) ordinarily reported upon in audit report when comparative financial statements are presented and reported upon.	Current year.	Current year.
Detailed disclosures in audit report.	• Identify the KAM and reference to related financial statement accounts and disclosures. • Describe why the matter was considered a KAM. • Describe how KAM was addressed in the audit (procedures, outcomes, observations).	• Identify the CAM. • Describe considerations that led to determination that it is a CAM. • Describe how the CAM was addressed in audit (procedures, outcomes, observations). • Refer to the related relevant financial statement accounts and disclosures.
Included in reports with qualified opinion, emphasis of matter, or other matter?	Yes.	Yes.
Included in reports with adverse or disclaimer of opinion?	No.	No.
Implementation	Audits of financial statements for periods <i>ending</i> on or after December 15, 2020.	Audits of financial statements for periods <i>ending</i> on or after June 30, 2019, for large accelerated filers (\$700 million public float); December 15, 2020, for other public companies.

We now turn our attention to circumstances resulting in modification of auditors' reports for both nonpublic and public companies.

Expression of an Opinion

The options when expressing an opinion on financial statements may be summarized as being either **unmodified** (referred to as **unqualified** for public companies) or **modified** as follows:

Unmodified Opinions

- *Unmodified (unqualified) opinion.* This report is issued when the auditors have obtained sufficient appropriate audit evidence to conclude that the financial statements, taken as a whole, are not materially misstated and there is no need to disclose additional information in the report.
- *Unmodified opinion—additional financial statement–related information included in audit report.* In certain circumstances, a *financial statement–related matter* is required to be described in the audit report through inclusion of an additional section. Examples include (1) situations in which there is substantial doubt about a company's ability to continue as a going concern and (2) situations in which the company makes a **change in accounting principle** followed that has a material effect on the financial statements (e.g., a change from FIFO to LIFO inventory valuation). In other circumstances, the auditors may choose to refer to certain matters, such as an uncertainty relating to future litigation, significant transactions with related parties, or unusually important subsequent events.
- *Unmodified opinion—additional audit-related information included in audit report.* In these circumstances, auditors add an additional section to the audit report to include a description of an *audit-related matter*. Such "other matter" is, in the auditors' judgment, relevant to users' understanding the audit, the auditors' responsibilities, or the auditors' report. Examples include matters such as (1) reporting on comparative statements when there are predecessor auditors and (2) alerting readers about the intended use of an audit report when it is not for general use (discussed in Chapter 19).
- *Unmodified opinion on group financial statements.* This circumstance involves a situation in which two or more CPA firms are involved in the audit of components that make up a set of group financial statements (e.g., one CPA firm may audit one subsidiary of a company while another CPA firm audits the parent company and the other subsidiaries). When the audit firm that does the majority of the audit work does not wish to take responsibility for the work of the other auditors, the audit report is modified to divide responsibility between the CPA firms. The report modification in this situation involves modifying existing paragraphs of the audit report and does not involve addition of a paragraph related to the matter.

Modified Opinions

- *Qualified opinion.* A **qualified opinion** states that the financial statements are presented fairly in conformity with generally accepted accounting principles "except for" the effects of some matter. Qualified opinions are issued when the financial statements are materially misstated ("a departure from GAAP") or when the auditors are unable to obtain sufficient appropriate audit evidence on which to base the opinion because of a **scope limitation**. In both cases, the likely effects, while **material**, are *not* considered **pervasive**. An additional paragraph describing significant reasons for the issuance of a qualified opinion is added to the audit report.
- *Adverse opinion.* An **adverse opinion** states that the financial statements are *not* presented fairly in conformity with generally accepted accounting principles. Auditors issue an adverse opinion when the deficiencies in the financial statements are both *material* and *pervasive*. All significant reasons for the issuance of an adverse opinion should be set forth in an additional paragraph added to the audit report.

- *Disclaimer of opinion.* A **disclaimer of opinion** most frequently is the result of a scope limitation that creates a situation in which the auditors are *unable to obtain sufficient appropriate audit evidence* on which to base the opinion, and they conclude that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive. A disclaimer is not an opinion; it simply states that the auditors do not express an opinion on the financial statements. As we discuss later in this chapter, disclaimers also may result from substantial doubt about a client's ability to continue as a going concern or multiple uncertainties relating to the financial statements. An additional paragraph describing significant reasons for the issuance of a disclaimer of opinion is added to the audit report.

We structure our discussion of audit reports around the two basic types of opinions just outlined: unmodified and modified opinions. Because several circumstances may result in either an unmodified or a modified opinion (e.g., substantial doubt about going concern status and uncertainties), we emphasize those circumstances that are encountered most frequently.

Reports with an Unmodified Opinion and Additional Financial Statement–Related Information Included

LO 17-3

Identify the circumstances that result in audit reports with unmodified opinions with additional financial statement-related information included.

The primary situations that result in an audit report with an unmodified opinion but with additional financial statement-related information include

- Substantial doubt about the company's going concern status.
- Generally accepted accounting principles not consistently applied.
- Other circumstances that the auditors believe should be emphasized (e.g., uncertainties, unusually important subsequent events, a major catastrophe, a division of responsibility for the total audit).

In each of the above circumstances, when appropriate accounting principles are followed and there are no material restrictions on the scope of the audit, the auditors may issue a report with an unmodified opinion. However, the auditing standards either require auditors to add information to the audit report related to the matter (the first two circumstances) or allow auditors to do so at their discretion (the third circumstance).

There are terminological differences between nonpublic and public auditing standards regarding the additional section (paragraph with a heading). Nonpublic company standards refer to the section created by this information as either an **emphasis-of-matter paragraph** or an **other-matter paragraph**. Public company standards refer to it either as an **explanatory paragraph** (first two bullets) or **emphasis of a matter** (third bullet).

Most of the "additional paragraphs" discussed in this part of the chapter require a title (heading). Because a paragraph with a title becomes a "section," a new section is added to the audit report (as discussed earlier in footnote 3). Thus, for example, a section indicating an inconsistent application of accounting principles between two years will consist of a title and an emphasis of matter (explanatory) paragraph.

In general, the section title must be one that the auditors consider appropriate.⁷ Although subject to some exceptions, placement of these additional sections within the report is governed by the following guidance:

- Nonpublic companies—The sections are included at a point following the Basis for Opinion section. The point is determined by the auditors based on the auditors'

⁷ Nonpublic company audit reports have several exceptions to the rule allowing the auditor to select the title. As discussed in the following section of this chapter, a report indicating substantial doubt about the entity's ability to continue as a going concern has a required title. Also, when a key audit matters paragraph is included, the title of any "Emphasis of Matter" or "Other Matter" section that is also included in the report must use that term, although it can be supplemented by a description of the matter. For example, "Emphasis of Matter—Uncertainties."

judgment of its nature and relative significance to intended users. While this will often be immediately following the Basis for Opinion section, it may be later in the report.

- Public companies—The sections on (1) substantial doubt about going concern status, (2) GAAP not consistently applied between years, and (3) correction of a material misstatement in previously issued financial statements are presented immediately following the Opinion section; other sections are placed where the auditors consider appropriate.

Substantial Doubt about a Company's Going Concern Status

Auditors are required to assess and report **substantial doubt** (and related uncertainties) about an entity's ability to continue as a going concern. An understanding of the accounting requirements relating to an entity's going concern status is helpful in understanding the auditors' responsibilities. Accordingly, in this section we first briefly recap the accounting guidance and then present the auditing requirements relating to a client's going concern status.

Accounting Requirements

Because assets and liabilities are ordinarily recorded, valued, and classified on the assumption that the company will continue to operate, the going concern status of an entity is a significant issue for users of financial statements. FASB *Accounting Standards Update No. 2014-15* (subtopic 205-40) requires management to consider the propriety of this assumption by evaluating whether there are conditions and events that raise *substantial doubt* about the entity's ability to continue as a going concern for a *reasonable period* of time, defined as one year after the date the financial statements are issued (or available to be issued). Substantial doubt exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due for a **reasonable period of time**. Examples of such conditions and events, depending upon the overall situation, that may raise substantial doubt include

- Negative cash flows from operations.
- Defaults on loan agreements.
- Arrearages on dividends.
- Adverse financial ratios.
- Work stoppage.
- Loss of a key franchise, customer, or supplier.
- An uninsured catastrophe.
- Legal proceedings.

In determining whether such conditions and events raise substantial doubt, management *initially* should consider them without reflecting the potential effects of its plans to mitigate the situation (e.g., plans to raise capital, borrow money, restructure debt, or dispose of assets). For example, if the company has defaulted on a loan agreement and management plans to attempt to obtain a new loan, obtaining the new loan would not be considered initially. Thus, the initial substantial doubt judgment is made prior to considering such management plans that have not been fully implemented.

When management has identified conditions and events suggesting substantial doubt, it is then required to consider whether it is probable that its plans will be effective in mitigating the effects of the conditions and events. At this point, a second substantial doubt judgment is required, one that considers the likely effectiveness of management's plans in alleviating the substantial doubt.

A financial statement footnote describing the situation is generally required when the initial judgment suggests substantial doubt. If management's plans result in alleviation of the substantial doubt, the footnote describes (1) the conditions and events, (2) management's evaluation of the significance of the conditions and events, and (3) its plans that alleviated the substantial doubt. If substantial doubt remains after consideration of

management's plan, the footnote should so indicate and the wording of disclosure item (3) should be modified to disclose management's plans that are intended to mitigate the conditions or events that raise substantial doubt.

Finally, the existence of substantial doubt indicates a question about whether the company will be able to meet its obligations as they become due. The accounting standards distinguish this situation from one in which "liquidation is imminent." The latter situation may be viewed as being beyond substantial doubt; that is, the company is in a situation requiring that it convert its assets and settle its obligations with creditors in anticipation of ceasing all activities. In this latter situation, GAAP requires that financial statement amounts be valued at their net realizable values.

Auditing Requirements—Approach

The professional auditing standards (AICPA AU-C 570; PCAOB AS 2415) require that, like management, auditors should evaluate whether there is substantial doubt about the client's ability to continue as a going concern for a reasonable period of time. While performing risk assessment procedures, the auditors should consider whether there are conditions and events that raise this substantial doubt. Also, throughout the audit, the auditors should remain alert for audit evidence of such conditions and events. The overall responsibilities for auditors are to (1) conclude, based on the audit evidence obtained, whether substantial doubt exists about an entity's ability to continue as a going concern for a reasonable period of time and (2) evaluate the possible financial statement effects, including the adequacy of disclosure regarding the entity's ability to continue as a going concern for a reasonable period of time. The auditors also should consider and discuss with management its evaluation of the organization's ability to continue as a going concern.⁸

As is the situation with the accounting requirements described earlier, the existence of substantial doubt is initially considered before considering management's plans and, when such substantial doubt has been identified, a second time after considering those plans. When audit evidence indicates substantial doubt prior to considering management's plans, additional procedures are required that involve evaluating management's plans for addressing the going concern situation. Auditors consider whether it is probable that the plans will be implemented and, if implemented, will mitigate the relevant conditions and events that raise substantial doubt.

In evaluating management's plans, the auditors should keep in mind the following requirements:

- When management's plans include a cash flow forecast, the auditors should evaluate the reliability of the underlying data and determine whether there is adequate support for the assumptions of the forecast.
- When management's plans include obtaining financial support from third parties or the entity's owner-manager, the auditors should obtain written evidence of the supporting party's intent and assess the ability of that party to provide such support.

Auditing Requirements—Reporting

Appropriate audit reporting relating to going concern status depends upon details of the situation, including whether substantial doubt about a client's ability to continue as a going concern for a reasonable period of time remains after considering management's plans and whether client disclosures and accounting are appropriate. For non-public audits, this reasonable period of time corresponds to the accounting requirement of one year from the date the financial statements are issued (or available to be issued);

⁸ In addition, AICPA and IAASB standards require that auditors inquire of management regarding its knowledge of conditions and events *beyond the period of management's required evaluation* that may have an effect on the entity's ability to continue as a going concern. While any such conditions or events will not affect the evaluation of whether substantial doubt exists, they may affect other disclosure requirements or consideration of whether the financial statements are fairly presented.



Illustrative Case

Going Concern Modification Issuance for Public Companies

Audit analytics provides percentage breakdowns of registrants receiving going concern

modifications in their audit reports by SEC category. The following represents averages for recent years:

SEC Category	Recent Percentages of Going Concern Modifications
Large accelerated filers (public float* > \$700 million)	0.5%
Accelerated filers (public float > \$75 to \$700 million)	5%
Smaller	37%
Overall	20%

*Public float is calculated by multiplying the number of the company's common shares held by non-affiliates by the market price and, in the case of an initial public offering, adding to that number the product obtained by multiplying the common shares covered by the registration statement by their estimated public offering price.

for public company audits, the auditing standards include a period not to exceed one year from the date of the financial statements.⁹

The going concern illustrative case provides PCAOB data on the frequency of issuance of public company going concern modifications.

Substantial Doubt About the Entity's Ability to Continue as a Going Concern

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations, has a net capital deficiency, and has stated that substantial doubt exists about the Company's ability to continue as a going concern. Management's evaluation of the events and conditions and management's plans regarding these matters also are described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. Our opinion is not modified with respect to this matter.

Substantial Doubt Remains after Considering Management's Plans When, after considering management's plans, the auditors conclude that substantial doubt continues to exist, for either a public or a nonpublic company, they should add a Going Concern section to their audit report. The opinion will remain unmodified unless the auditors decide to disclaim an opinion due to the significance of the uncertainty.¹⁰

The exact title illustrated above is required for nonpublic company reports, while public company reports require "an appropriate title." Guidance on the placement of the section is presented in Figure 17.3.

⁹ For audits of public companies, the "reasonable period" concept gets somewhat complicated. Because the auditors must provide an opinion on whether the financial statements follow GAAP, and because management must consider a period of one year from the issuance of the financial statements, in considering management's disclosures the auditors use that longer period. But, in forming their own decision, they use the shorter period, a period not to exceed one year from the date of the financial statements.

¹⁰ In a nonpublic company audit, substantial doubt about an entity's ability to continue as a going concern requires a Going Concern section and is considered a key audit matter. When the auditors are reporting on key audit matters, the matter is required to be discussed in a Going Concern section, with a reference to it in the Key Audit Matters Section. In a public company audit, substantial doubt about an entity's ability to continue as a going concern will also require a Going Concern section, and may or may not be considered a critical audit matter. For example, substantial doubt will require a Going Concern explanatory section and may also be considered a CAM. In such a situation, the auditors may include the information in the explanatory paragraph, with a cross reference in the CAM section. Alternatively, the auditors may include both matters separately in the audit report and add a cross-reference between the two sections.

FIGURE 17.3 Summary of Selected Additional Sections* Added to a Report with an Unmodified Opinion and Group Audits

Matter Giving Rise to Additional Paragraph (Primary Professional Standard)	Nonpublic Company Audit Report	Public Company Audit Report
Going Concern —Substantial doubt about ability to continue as a going concern. (AICPA AU-C 570; PCAOB AS-2415)	Unmodified opinion with an additional titled section. The section is placed at an appropriate point following the Basis for Opinion section. The exact order of it and remaining sections depends upon the nature of information and auditor's judgment of relative significance of various audit report sections following the Basis for Opinion section.	Unmodified opinion with an additional titled section following the opinion section.
Consistency —GAAP not consistently applied. (AICPA AU-C 708; PCAOB AS 2820)		
Correction of a Material Misstatement in Previously Issued Financial Statements. (AICPA AU-C 708; PCAOB AS 2820)		
Auditor discretionary —For example, uncertainty, major catastrophe, significant related party transaction, significant subsequent event. (AICPA AU-C 708; PCAOB AS 3101)	Same as above.	Unmodified opinion with an additional titled section that may be placed where the auditor considers appropriate.
Group Audits. (AICPA AU-C 600; PCAOB AS 1201, 1206, 2101)	Unmodified opinion. Component auditor (<i>Other auditor</i> , per PCAOB) is not referred to in the audit report. Referred-to auditor is referenced in the opinion section.	

*AICPA auditing standards in general use the term *emphasis-of-matter*, although "Going Concern section" is used for substantial doubt about going concern status. PCAOB standards use the term *explanatory paragraph* for going concern and consistency additional paragraphs and *emphasis of a matter* (or simply, *emphasis*) paragraph for the auditor discretionary circumstances.

Substantial Doubt Does Not Remain after Considering Management's Plans When management has properly disclosed the situation and indicates that the substantial doubt does not exist due to its plans for dealing with the financial difficulties, an Emphasis of Matter section may, at the auditors' discretion, be added. The following is an example of this section:

[Appropriate Title]

As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency. Management's evaluation of the events and conditions and management's plans to mitigate these matters also are described in Note X. Our opinion is not modified with respect to this matter.

For either a public or a nonpublic company, the section may be presented at an appropriate place in the audit report, although for a nonpublic company that point should be after the Basis for Opinion section.

Client Financial Statement Disclosures Concerning the Substantial Doubt (or Alleviated Substantial Doubt) Are Inadequate When client disclosures relating to going concern status are not adequate, including when management concludes that substantial doubt does not exist when the auditors believe that it does, the financial statements contain a departure from generally accepted accounting principles. In these situations, the auditors will issue either a qualified opinion or an adverse opinion. Examples of reports for GAAP departures are presented later in this chapter.

Liquidation Basis Issue As indicated earlier, GAAP requires that if and when an entity's liquidation becomes imminent, financial statements should be prepared under the liquidation basis of accounting. A company that is about to liquidate (or is in liquidation) but follows the going concern basis of accounting is departing from GAAP. Material departures from GAAP ordinarily result in either a qualified opinion or an adverse opinion depending upon whether the auditors believe the financial statements are pervasively misstated.

Generally Accepted Accounting Principles Not Consistently Applied

U.S. auditing standards for both public and nonpublic companies (AICPA AU-C 708; PCAOB AS 2820) require that auditors evaluate the client's current-period financial statements for consistency of application of accounting principles in relation to prior periods. What periods should be considered in this evaluation? Both sets of auditing standards base that decision on the periods covered by the auditors' report on the financial statements.

- When the auditors are reporting only on the current period, they should evaluate whether the current-period financial statements are consistent with those of the preceding period, regardless of whether the preceding period is presented.
- When the auditors are reporting on two or more periods, they should evaluate consistency between such periods and the consistency of such periods with the period prior thereto if that prior period is presented with the financial statements being reported upon.

When the client makes a **change in accounting principles**, the nature of, justification for, and effect of the change are reported in a note to the financial statements for the period in which the change is made. The auditors should evaluate the change by determining whether it meets the following four accounting requirements:

1. The newly adopted principle is generally accepted.
2. The method of accounting for the effect of the change is in conformity with GAAP.
3. The disclosures related to the change are adequate.
4. Management has justified that the new accounting principle is preferable.

When the auditors believe that the new principle meets the four requirements, an additional section is added to the audit report to highlight the lack of consistent application of accounting principles; but the opinion remains unmodified.¹¹ Following is an example of an additional section on consistent application of accounting principles:

Change in Accounting Principle

As discussed in Note 2 to the consolidated financial statements, the Company changed the manner in which it accounts for revenues from contracts with customers in 20X2. Our opinion is not modified with respect to this matter.

Guidance for placement of the paragraph is included in Figure 17.3,

Conceptually, a change in accounting principles might relate to a matter that is considered to be a key or critical audit matter. For example, a change in accounting valuation methods for inventory might, in some circumstances, represent a KAM or a CAM. The AICPA requirements for KAMs in such a situation (when being reported upon) result in the matter only being described in the KAM section, without the above additional section. The PCAOB CAM requirements allow either (1) description of the accounting change in the above section and a reference to that section in the CAM section or (2) description separately in both sections.

When the auditors believe that the new principle does not meet one or more of the four requirements, a departure from generally accepted accounting principles exists. In such a circumstance, the auditors should issue either a qualified or an adverse opinion.

Certain situations ordinarily *do not* result in an Emphasis of Matter section on consistency. These include changes in accounting estimates (e.g., changing the life of a fixed asset) and changes in principles with an immaterial effect on the financial statements (even if the effects are expected to be material in the future). Finally, because consistency is a between-periods concept, a consistency modification is not appropriate for a company in the first year of its existence.

¹¹ *International Standards on Auditing* (ISA 706) allow, but do not require, an emphasis-of-matter paragraph relating to a properly accounted-for change in accounting principles.

Correction of a Misstatement

A client's correction of a material misstatement in previously issued financial statements also results in addition of an additional section to the audit report (AICPA AU-C 708; PCAOB AS 2820). The section is only included in the year it occurs and includes a statement that the previously issued financial statements have been restated for correction of a material misstatement and a reference to the entity's disclosure of the correction in the notes to the financial statements. Guidance on placement of this section is presented in Figure 17.3.

**Additional
Financial
Statement–Related
Information
Added—Auditor
Discretionary
Circumstances**

In certain other circumstances, the auditors may decide to include an additional section even though it is not required (AU-C 708; PCAOB AS 3101).¹² Auditors add such a section to their audit report when, although the information is appropriately presented or disclosed in the financial statements, in their professional judgment it is of such importance that it is fundamental to users' understanding of the financial statements.

Uncertainties

Uncertainties are situations in which conclusive audit evidence concerning the ultimate future outcome of an event cannot be expected to exist at the time of the audit. While all financial statements are affected to some extent by uncertainties, it is only for those whose outcome is unusually important that auditors consider adding an Emphasis of Matter section. As an example, an unusually important ongoing litigation or regulatory action in process against the client might be considered unusually important. The following illustrates an Emphasis of Matter section describing an uncertainty:

[Appropriate Title]

As discussed in Note X to the financial statements, the company is a defendant in a lawsuit [briefly describe the nature of the litigation consistent with the Company's description in the note to the financial statements]. Our opinion is not modified with respect to this matter.

Adding a section for matters such as the above is at the discretion of the auditors. A major assumption underlying the inclusion of such an additional section is that the matter is adequately disclosed in the notes to the financial statements. The auditors simply choose to also emphasize it. For nonpublic and public company audit reports, the section may be placed where the auditors consider appropriate, although for a nonpublic company that point should follow the Basis for Opinion section.

When key (critical) audit matters are being reported upon, and when a matter described above in this section is a KAM (CAM), the matter is generally only reported upon in the KAM (CAM) section.

While a report with an unmodified opinion and an additional Emphasis of Matter section is the most frequent resolution regarding a particularly important uncertainty, there are situations in which a disclaimer may be issued. When multiple uncertainties cause the auditors to conclude that it is not possible to form an opinion on the financial statements as a whole due to the interaction and cumulative possible effects of the uncertainties, a disclaimer may be appropriate.

If an uncertainty is *not* adequately disclosed in the financial statements, a departure from GAAP exists. In this circumstance either a qualified or an adverse opinion is appropriate.

¹² These reports also are referred to as including an "emphasis of matter" paragraph (section) in nonpublic company standards. Recall that the PCAOB uses similar terminology for this section but refers to the reports prior to this section as having explanatory language or an explanatory paragraph (section).

Additional Circumstances That May Result in an Emphasis of Matter Section

Auditors also, at their own discretion, may choose to add an Emphasis of Matter section to a report with an unmodified opinion for other circumstances relating to the financial statements. Examples of such matters include

- A major catastrophe that has had, or continues to have, a significant effect on the organization.
- Significant transactions with related parties.
- The audited company is a component of a larger business enterprise.
- Unusually important subsequent events.

The following, abstracted from the 2019 Nordstrom, Inc. audit report, relates to the effects of the novel coronavirus pandemic that occurred subsequent to year-end:

Emphasis of a Matter

As discussed within Note 1 to the financial statements, *Subsequent Events*, effective March 17, 2020, the Company announced the temporary closure of its stores in the U.S. and Canada for two weeks in response to the novel coronavirus (COVID-19) and that the impacts of COVID-19 may have a material adverse impact on its results of operations, financial position and cash flows in 2020. Additionally, the Company drew \$800 million on its revolving credit line in March 2020.

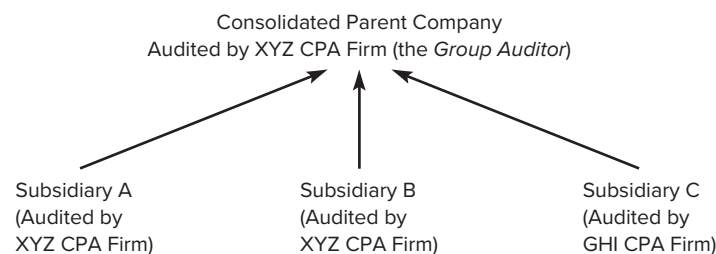
Note that the matter should relate to the financial statements, not to details of the audit itself.

Group Financial Statements

Group financial statements are those of a company that consists of more than one entity or business unit (e.g., a company with subsidiaries) through a consolidation process. Many companies present such financial statements, often with one CPA firm auditing the entire company. That CPA firm issues an audit report on the consolidated financial statements and, possibly, on one or more of the **components** depending upon the client's needs.

In other situations, more than one audit firm is involved in the auditing of consolidated financial statements. For example, a company may have acquired another company and part of the acquisition agreement is that the acquired firm may keep its auditors (another CPA firm) for a period of time. Consider the company presented in Figure 17.4, composed of a parent company and three subsidiaries.

FIGURE 17.4



Except for Subsidiary C, the entire audit is performed by XYZ, the **group auditor**. Assume, as is ordinarily the case, that an audit report is required *on the overall consolidated financial statements*. Situations such as this, with multiple auditing firms involved, raise a number of issues. This is primarily due to the need to determine (and meet) the responsibilities of the various auditors to obtain sufficient appropriate audit evidence to provide a reasonable basis for an audit opinion on the *overall consolidated financial statements*.

Group Auditor

When more than one audit firm is involved in an audit, the group auditor (*lead auditor* per PCAOB) is the audit firm that issues the audit report on the company's consolidated

financial statements. As with other audits, the prospective group auditor addresses engagement acceptance and continuance issues. In determining whether a firm is able to serve as the group auditor, factors such as the following are considered:

- The importance of components that the group auditor will audit as compared to all the components.
- The risks of material misstatement the group auditor will address versus those addressed by the additional audit firm(s).
- Whether the group auditor has the ability to properly supervise the audit.

The involvement of one or more additional audit firms in the engagement requires the group auditor to consider information such as the availability of evidence on the overall group controls, the consolidation process, and the financial information of the components. In addition, the group auditor should obtain an understanding of

- Whether the personnel of the additional audit firm are able to perform the desired procedures, and whether that firm operates in a regulatory environment with proper oversight and will comply with all ethical requirements.
- The extent to which the group auditor will be involved with additional audit firm personnel, and whether it will be able to obtain necessary information on the consolidation process from the component auditors.

Under both AICPA (AU-C 600) and PCAOB (primarily PCAOB AS 1201, 1206, and 2101) standards, the extent of another audit firm's involvement will be affected by which one of the following basic reporting approaches is adopted by the group auditor:

1. **Component auditor** (*Other Auditor* under PCAOB standards).
2. **Referred-to auditor.**¹³

Component Auditor Approach

Figure 17.4 may be viewed as illustrating a situation in which a component auditor approach is adopted by the group auditor. Using this approach, the engagement team members of the component auditor (GHI) are considered members of the **engagement team** headed by the **group engagement partner**. The group auditor supervises the work of the component auditor as it relates to the consolidated financial statements and *does not make reference* to that auditor in its audit report on the consolidated financial statements. Also, the group auditor partner determines an approach to obtain sufficient appropriate audit evidence to identify, assess, and respond to the risks of material misstatement of the consolidated financial statements. This approach may, and often will, involve audit procedures being performed by the group auditors at the component level. Determining the components at which audit procedures are to be performed, and the nature, timing, and extent of further audit procedures to be performed at the selected components, are matters of professional judgment.

The group auditor establishes the overall **group audit** strategy and audit plan and takes responsibility for the nature, timing, and extent of the procedures performed. In its supervision of the component auditor, the group auditor

- Directs and reviews the component auditor's work, emphasizing areas of higher assessed risks of material misstatement and areas of the consolidated financial statements that involved significant judgment.
- Communicates about matters such as significant risks, such as related party relationships and going concern status.
- Evaluates the conclusions drawn from the audit evidence obtained for forming an opinion on the consolidated financial statements.

¹³ The PCAOB does not allow use of the referred-to auditor approach if the lead auditor's firm does not audit more than 50 percent of the company's assets or revenues. International standard *ISA 600 (Revised)* does not allow use of the approach unless required by law or regulation.

When the group auditor becomes satisfied with the work of the component auditor, it assumes responsibility for the entire audit of the consolidated financial statements and makes no reference to the component auditor in the report.

Referred-to Auditor Approach

The referred-to auditor approach obtains its name because using this approach, the group auditor makes reference to the referred-to auditor in its audit report on the consolidated financial statements. This is a bit tricky in that, although a referred-to auditor audits a component of the overall consolidated company, that auditor is not considered a “component auditor” as described in the preceding section. Also, unlike the component auditor approach, the referred-to auditor is not considered a part of the engagement team led by the group engagement partner.

Auditors may follow this approach if the referred-to auditor is so informed and

- The referred-to auditor indicates that it has issued the auditor’s report in accordance with the appropriate standards (e.g., GAAS or PCAOB auditing standards) and the group auditor, based on inquiries and appropriate other procedures, confirms this.
- The group auditor determines that the referred-to auditor is familiar with the overall appropriate requirements (e.g., the financial accounting framework, GAAS, PCAOB standards, and SEC requirements as appropriate).
- If required, the referred-to auditor is registered with any appropriate bodies (e.g., PCAOB when a public company is involved, and the referred-to auditor had a substantial role in the audit).

Historically, this type of report on the consolidated financial statements has often been called a *shared responsibility opinion*, although it is signed only by the group auditor. In many circumstances, the group auditor and referred-to auditor will discuss related party matters and significant risks that are relevant to the referred-to auditor.

When the group auditor decides to use the referred-to auditor approach, it uses that auditor’s work to assist in auditing the consolidation process and also reads the component’s financial statements and the referred-to audit report to identify significant findings and issues. If the group auditor is not satisfied with any of the above requirements having been met, or with the work of the referred-to auditor, the group auditor may plan and perform additional procedures, appropriately qualify or disclaim an opinion, or withdraw from the engagement.

Audit Reports with Referred-to Auditors The Opinion Section of a group audit report on the consolidated financial statements indicates the portion of the engagement performed by the referred-to auditors in terms of dollars and percentages.

A nonpublic company audit report may either state that “other auditors” are being relied upon (with percentages or dollars involved of assets or revenues) or name the referred-to auditor. The following is an example of the audit report modifications when the referred-to auditor is not named:

Opinion

[Standard first paragraph “We have audited. . . .]

In our opinion, based on our audit *and the report of the other auditors*, the accompanying consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

We did not audit the financial statements of B Company, a wholly owned subsidiary, whose statements reflect total assets constituting 20 percent of consolidated total assets at December 31, 20X1, and total revenues constituting 18 percent of consolidated total revenues for the year then ended. Those statements were audited by other auditors, whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.



Illustrative Case

Audits of Public Companies That Have Multiple Audit Firms Involved

The Public Company Accounting Oversight Board provided data relating to audits with multiple audit firms involved (PCAOB Release No. 2021-002, Docket Matter No. 042).

Situation	Percentage
Percentage of audits that include multiple audit firms of	
• All issuer (SEC registrants) audits performed	26%
• Fortune 500 issuers	68%
• Audits performed by the largest 6 CPA firms*	39%
Additional audit firms when multiple firms involved:	
• 1 other audit firm	39%
• 2–4 other audit firms	33%
• 5–9 other audit firms	17%
• 10–19 other audit firms	9%
• 20 or more other auditor firms	2%
Level of additional audit firms' share of total audit hours.	
• Less than 10% of total audit hours	48%
• Less than 30% of total audit hours	81%
Average number of reports that refer to the work of other auditors annually	40

*The "Big 4" CPA firms plus BDO and Grant Thornton.

When the referred-to auditor is named, the group auditor obtains the referred-to auditor's permission and includes with the consolidated financial statements that referred-to auditor's report in addition to its own.

The requirements for reports under PCAOB standards are similar to AICPA standards. However, under PCAOB standards, the referred-to auditor's name is always included in the group auditor's report, although the referred-to auditor's report is not presented with the group audit report.¹⁴

What happens when the referred-to auditor modifies its opinion on the component financial statements? In such a situation, are the group auditors required to also modify their opinion on the consolidated financial statements? The answer to this question depends on the *materiality* of the matter. The consolidated financial statements ordinarily will have much larger amounts and totals than those of the component. Matters that were material to the component's financial statements may be quite insignificant to the consolidated entity. Therefore, to determine whether a qualification of the consolidated financial statements is required, the group auditor must evaluate the materiality of the matter *in relation to the consolidated financial statements*.

The Illustrative Case *Audits of Public Companies That Have Multiple Audit Firms Involved* describes overall historical information on how often more than one CPA firm is involved in public company audits.

¹⁴ The referred-to auditor's report is generally available in that it is filed with the SEC (see Regulation S-X Rule 2-05, 17 C.F.R. § 210.2-05).

Modified Opinions

LO 17-4

Identify the circumstances that result in audit reports with modified audit opinions.

Modified opinions (AICPA AU-C 705; PCAOB AS 3105) are required in two circumstances:

- *Materially misstated financial statements (i.e., a “departure from GAAP”)*—The auditors conclude that the financial statements as a whole are materially misstated.
- *Inability to obtain sufficient appropriate audit evidence (i.e., a “scope limitation”)*—The auditors are unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatements.

Recall from earlier in the chapter the three types of modified opinions: qualified opinions, adverse opinions, and disclaimers of opinion. Figure 17.5 describes the situations in which each type of modified opinion is issued.

FIGURE 17.5 Modified Audit Opinions

Nature of Matter Giving Rise to the Modification	Auditors' Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements		
	Not Material (Accordingly, also Not Pervasive)	Material but Not Pervasive	Material and Pervasive
<i>Misstated Financial Statements (Departure from GAAP)</i>	Unmodified	Qualified	Adverse
<i>Inability to Obtain Sufficient Appropriate Audit Evidence (Scope Limitation)</i>	Unmodified	Qualified	Disclaimer

As indicated in Figure 17.5, materially misstated financial statements result in either a qualified opinion or an adverse opinion depending on the size and pervasiveness of the misstatement. Similarly, an inability to obtain sufficient appropriate audit evidence leads to either a qualified opinion or a disclaimer opinion based on the *possible effects* on the financial statements of undetected misstatements. In both situations, the decision is based on whether misstatements or possible misstatements are both *material and pervasive*.

In the context of misstatements, *pervasive* is the term used to describe the effects on the financial statements of misstatements (departures from GAAP) or the possible effects on the financial statements of misstatements (scope limitations). Effects of misstatements become pervasive when, in the auditors' judgment, they meet one or more of the following three criteria:

- They are not confined to specific elements, accounts, or items of the financial statements.
- If confined, they represent or could represent a substantial proportion of the financial statements.
- In relation to disclosures, they are fundamental to users' understanding of the financial statements.

The form of the audit report with a modified opinion differs somewhat for nonpublic and public companies. Recall that the first two sections of reports of nonpublic and public companies with unmodified (unqualified) opinions are titled “Opinion” and “Basis for Opinion.” When the opinion is modified (as indicated in Figure 17.6), the Opinion

and Basis for Opinion section titles for the nonpublic company report are made more descriptive by including the type of opinion issued (e.g., “Qualified Opinion” and “Basis for Qualified Opinion”), whereas the titles are not changed for public company reports unless a disclaimer of opinion is being issued. For both nonpublic and public company audit reports, the modification language (e.g., “except for” in a qualified opinion) is added to the sentence in the opinion paragraph that begins with “In our opinion,” as shown in Figure 17.6.

FIGURE 17.6 Illustration of Difference in Reporting Formats for a Modified (Qualified Example) Audit Report

Nonpublic Company (AICPA ASB)	Public Company (PCAOB)
Qualified Opinion We have audited the financial statements of ABC Company, which comprise the balance sheets as of December 31, 20X1 and 20X0, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements. In our opinion, <i>except for the effects of the matter described in the Basis for Qualified Opinion section of our report</i>, the accompanying financial statements present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1 and 20X0, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.	Opinion on the Financial Statements* We have audited the accompanying balance sheets of ABC Company as of December 31, 20X1 and 20X0, the related statements of income, changes in stockholders' equity, and cash flows for each of the three years then ended, and the related notes to the financial statements. In our opinion <i>except for the effects of the accounting for inventories</i>, the financial statements present fairly, in all material respect, the financial position of ABC Company as of December 31, 20X1 and 20X0, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. <i>As discussed in Note X to the financial statements, the Company has stated inventories at cost in the accompanying balance sheets. Accounting principles generally accepted in the United States of America require inventories to be stated at the lower of cost or market. If the Company stated inventories at the lower of cost or market, a write down of . . . (describe effects)</i>
Basis for Qualified Opinion <i>As discussed in Note X to the financial statements, the Company has stated inventories at cost in the accompanying balance sheets. Accounting principles generally accepted in the United States of America require inventories to be stated at the lower of cost or market. If the Company stated inventories at the lower of cost or market, a write down of . . . (describe effects)</i> The above paragraph is followed by the same paragraph included in an unmodified report paragraph (“We conducted our audits in accordance with auditing standards. . . .”)	Basis for Opinion (no changes from the unqualified report)

*When an integrated audit has been performed, a paragraph on the audit of internal control over financial reporting is added to the Opinion section.

The larger formatting difference between nonpublic company reports and public company reports is that for nonpublic companies, the reason for the modification is included in the Basis for (Qualified, Adverse, or Disclaimer of) Opinion section, while for public company reports, the reason is included in the Opinion section (Figure 17.6). Notice that, unlike most of the additional paragraphs discussed in the preceding section on reports with unmodified opinions, the additional paragraph for reports with modified opinions is included in an existing section and does not result in creation of a new section.

Following are discussions of modified opinions for (1) misstated financial statements and (2) the inability to obtain sufficient appropriate audit evidence.

Materially Misstated Financial Statements ("Departures from GAAP")

Auditors sometimes conclude that the financial statements are misstated. As indicated in Figure 17.5, they should consider the materiality of the effects of any departure from GAAP to determine the appropriate type of audit report to issue. When the effects of the departures are *immaterial*, an unmodified opinion may be issued; when the effects are *material*, the auditors should issue either a qualified opinion or an adverse opinion based on whether the misstatement is considered pervasive.

The distinction between the effects of departures from generally accepted accounting principles that are material but not pervasive and those that are material and pervasive is a matter of professional judgment. In the discussions that follow, it will not be practical to present sufficient detail for readers to make these judgments. Therefore, for material misstatements, we will either (1) explicitly indicate whether the misstatement is pervasive or (2) use terms from the criteria for when a misstatement is pervasive, such as "a substantial proportion of the financial statements" or "fundamental to users' understanding."

As discussed previously, when the report on a nonpublic company is qualified for a departure from GAAP, the modification involves qualifying the opinion (including the section title) and describing the reason for the qualification in a first paragraph added to what becomes titled the Basis for Qualified Opinion section. The report's other paragraphs would contain standard wording. The left side of Figure 17.6 illustrates the modifications of a nonpublic company audit report.

The audit report for a public company that is qualified for a departure from GAAP includes an additional paragraph that follows the opinion paragraph in the Opinion section and does not include a title, as illustrated on the right side of Figure 17.6. Notice that all modifications for the public company audit report are in the Opinion section. Figure 17.7 expands the description of modifications for reports with adverse opinions and disclaimers of opinion.

If the material misstatement is considered pervasive, an *adverse opinion* is appropriate. An adverse opinion is the opposite of an unmodified opinion; it states that the financial statements *do not* present fairly the financial position, results of operations, and cash flows. When the auditors express an adverse opinion for a nonpublic company, the Basis for Adverse Opinion section is similar to that of a report with a qualified opinion, as illustrated in Figure 17.6. An illustration of an Adverse Opinion section for a nonpublic company follows:

Adverse Opinion

We have audited the balance sheet as of December 31, 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements.

In our opinion, *because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph*, the consolidated financial statements referred to above *do not express fairly* the financial position of Wend Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended.

Figure 17.7 summarizes audit report changes required by an adverse opinion for both nonpublic and public companies.

FIGURE 17.7 Audit Reports with Modified Opinions: Major Changes from Unmodified* Opinions

	Nonpublic Company (AICPA ASB)	Public Company (PCAOB)
Professional Standard with Details	AICPA AU-C 705	PCAOB AS-3105
Qualified Opinion (Departures from GAAP and Scope Limitations)	Opinion section - Title becomes "Qualified Opinion" - After "In our opinion," add "except for the effects of . . .," Basis for Opinion section - Title becomes "Basis for Qualified Opinion" - Add a first paragraph describing the matter	Opinion section - After "In our Opinion," add "except for the effects of . . .," - Add a paragraph describing the matter Basis for Opinion section - GAAP departure—No change - Scope limitation—"Except as discussed above" added to standard second paragraph ("Except as discussed above, we conducted our audit . . .")
Adverse Opinion (Departures from GAAP)	Opinion section - Title becomes "Adverse Opinion" - Conclusion is that financial statements are not in conformity with GAAP Basis for Opinion section - Title becomes "Basis for Adverse Opinion" - Add a first paragraph describing the matter No KAM section included in report	Opinion section - Conclusion is that financial statements are not in conformity with GAAP. - Paragraph added describing the matter Basis for Opinion section - No change No CAM section included in report
Disclaimer of Opinion (Scope limitations)	Opinion section - Title becomes "Disclaimer of Opinion" - Conclusion is that auditors are unable to obtain sufficient appropriate audit evidence to provide a basis for an opinion. Basis for Opinion section - Title becomes "Basis for Disclaimer of Opinion" - Composed of a paragraph describing the matter - The paragraph outlining the nature of the audit ("We conducted our audit. . .") is omitted. No KAM section included in report	Opinion section - Title becomes "Disclaimer of Opinion on the Financial Statements" - Conclusion is that auditors are unable to obtain sufficient appropriate audit evidence to provide a basis for an opinion. - Paragraph added describing the matter Basis for Opinion section - Title becomes "Basis for Disclaimer of Opinion" - The paragraph outlining the nature of the audit ("We conducted our audit. . .") is omitted. No CAM section included in report.

*Reports with unmodified opinions and no other circumstances involved presented in first major section of this chapter.

A material misstatement may exist due to the omission of information; that is, disclosures required by GAAP for a fair presentation may have been omitted. In such a circumstance, if, after communicating with those charged with governance, the information is still considered necessary and omitted, the auditors will issue a qualified or adverse opinion based upon the pervasiveness of the resulting misstatement.¹⁵

The professional standards require auditors to describe the nature of the omitted information and include the omitted information if it is practicable to do so. Practicable, as used here, means that the information is reasonably obtainable from the accounts and records and that in providing the information in the report, the auditors do not assume

¹⁵ As indicated in footnote 1, GAAP require that when a balance sheet and an income statement are presented, a statement of cash flows also should be presented and its omission is a departure from GAAP. Historically, this has led to a qualified opinion, although the current GAAS standards are silent on whether a qualified opinion or an adverse opinion should be issued. PCAOB standards state that such omission normally results in a qualified opinion. *International Auditing Standards* do not explicitly address omission of the statement of cash flows.

the position of a preparer of the financial statements. For example, the auditors would not be expected to prepare a basic financial statement or segment information and include it in the auditors' report when management omits such information. Also, disclosing the information in the audit report would not be practicable if the information, in the auditors' judgment, would be unduly voluminous in relation to the auditors' report.

Ordinarily, a client that is reluctant to make a particular disclosure would rather disclose the information in a note than have it highlighted in the auditors' report. Therefore, very few auditors' reports actually are qualified because of inadequate disclosure. Instead, the requirements of the professional standards usually convince the client to include the necessary disclosure among the notes to the financial statements.¹⁶ Also, the Securities and Exchange Commission in general does not accept filings that include a qualified or adverse audit opinion due to departures from generally accepted accounting principles.

**Inability to
Obtain Sufficient
Appropriate Audit
Evidence (Scope
Limitation)**

Limitations on the scope of an audit may create a situation in which the auditors are unable to obtain sufficient appropriate audit evidence. Such limitations may occur due to:

- Circumstances beyond the control of the client (e.g., important accounting records were destroyed).
- Circumstances relating to the nature and timing of the auditors' work (e.g., the auditors are hired too late to observe the client's beginning inventory¹⁷).
- Client-imposed limitations (e.g., the client's refusal to allow the auditors to send confirmations to customers).

Client-imposed limitations are particularly significant because they may have other implications for the audit, such as for the auditors' assessment of fraud risks and consideration of whether to continue the engagement or to withdraw. If management imposes a limitation, the auditors should communicate the limitation to those charged with governance.

When a scope limitation is encountered, the auditors attempt to obtain sufficient appropriate audit evidence by performing alternative procedures. If those procedures provide the required evidence, no report modification is necessary. If they do not, a decision needs to be made about whether a qualified opinion is necessary or whether the possible effects on the financial statements are so pervasive as to require a disclaimer of opinion. Also, PCAOB standards state that when a significant scope limitation is imposed by the client, the auditors ordinarily should disclaim an opinion on the financial statements.

If the auditors of a nonpublic company decide that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, a qualified opinion is appropriate. The nonpublic company audit report will include a modification of the Opinion and Basis for Opinion sections as follows (the remainder of the report uses the standard wording):

¹⁶ The Accounting Principles Rule (ET 1.320) of the AICPA *Code of Professional Conduct* recognizes that in unusual circumstances, a departure from accounting principles may be justified. However, the FASB does not allow such a departure from authoritative body pronouncements and this type of report is not generally issued. Under a financial reporting framework that allows such a departure, and if the auditors agree the departure is justified, they may issue a report with an unmodified opinion, but they must disclose the departure in an emphasis-of-matter paragraph after the opinion paragraph. When the auditors do not agree that the departure is justified, a qualified or an adverse opinion is appropriate. Note that it is very seldom that the auditors would consider such a departure as justified under any financial reporting framework.

¹⁷ Note that even though this may be the "fault" of the client, it is not considered a limitation imposed by management because the client is not refusing to allow the auditors to perform a procedure that is possible to perform. Professional standards relating to nonpublic and public companies are included in AICPA AU-C 705 and PCAOB AS 3105, respectively.

Qualified Opinion

We have audited the financial statements of ABC Company, which comprise the balance sheet as of December 31, 20X1, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements.

In our opinion, *except for the possible effects of the matter described in the Basis for Qualified Opinion section of our report*, the accompanying financial statements present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Basis for Qualified Opinion

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at \$20,500,000, or its equity in earnings of that affiliate of \$6,250,450, which is included in net income, as described in Note 8 to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in earnings by other auditing procedures.

Followed by Standard Basis for Opinion Paragraph: "We conducted our audit in accordance with auditing standards. . . ."

Notice in the opinion paragraph that the qualification is worded as being due to the possible effects of the matter(s) on the financial statements, and not to the scope limitation itself. Figure 17.7 summarizes audit report changes required by a qualified opinion due to a scope limitation for both nonpublic and public companies.

When the auditors conclude that the possible effects on the financial statements could be both material and pervasive, a disclaimer of opinion is appropriate. A disclaimer of opinion is no opinion. Auditors issue a disclaimer whenever they are unable to form an opinion or have not formed an opinion as to the fairness of presentation of the financial statements. The following is an example of the paragraphs modified when a disclaimer of opinion is issued to a nonpublic company:

Disclaimer of Opinion

We were engaged to audit the accompanying financial statements of Wend Company, which comprise the balance sheet as of December 31, 20X8, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements. We do not express an opinion on the accompanying financial statements of ABC Company. Because of the significance of the matters described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for Disclaimer of Opinion

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at \$20,500,000, or its equity in earnings of that affiliate of \$6,250,450, which is included in net income, as described in Note 8 to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in earnings by other auditing procedures.

Figure 17.7 summarizes audit report changes required by an adverse opinion for both nonpublic and public companies.

Scope Limitations versus Uncertainties

It is important to be able to distinguish between an inability to obtain sufficient appropriate audit evidence (a scope limitation) and an uncertainty. This is because a scope limitation may result in either a qualified opinion or a disclaimer of opinion, while an uncertainty may result in a report with an unmodified opinion and an emphasis-of-matter paragraph (or, less frequently, a disclaimer of opinion).

An inability to obtain sufficient appropriate audit evidence (a scope limitation) occurs in situations in which audit evidence should be available and is not—due to circumstances beyond the control of the organization, circumstances dealing with the timing of the auditors' work, or limitations imposed by management. Alternatively, an uncertainty involves a situation that is expected to be resolved at a future date, at which time conclusive audit evidence concerning its outcome would be expected to become available.

Complicating the matter is the fact that a situation involving an uncertainty also may involve a scope limitation. As an example, assume that an uncertainty exists relating to the future outcome of a lawsuit against the company. Also assume that the lawyer engaged by the client who has devoted substantive attention to the matter refuses to provide appropriate information on the uncertainty. Here the lawyer's refusal to reply may result in a lack of sufficient appropriate audit evidence (a scope limitation) relating to the litigation (an uncertainty). The appropriate audit opinion would be either a qualified opinion or a disclaimer of opinion.

A Disclaimer Is Not an Alternative to an Adverse Opinion

A disclaimer cannot be issued when the auditors have formed an opinion on the financial statements. For example, if the auditors have already formed an opinion that the financial statements are materially and pervasively misstated, an adverse opinion is appropriate. A disclaimer of opinion cannot be used as a way to avoid expressing an adverse opinion. In fact, even when auditors issue a disclaimer of opinion, they should express in the basis-for-opinion paragraph of their report any and all material reservations they have concerning the financial statements. These reservations would include any material departures from generally accepted accounting principles, including inadequate disclosure. In short, the issuance of a disclaimer can never be used to avoid warning financial statement users about problems that the auditors know exist in the financial statements.

Effects of Opinion Modification on Reporting of Key (Critical) Audit Matters

Recall that the types of modified opinions are qualified, adverse, and disclaimers. As we have indicated earlier in this chapter, CAM and KAM sections are omitted from nonpublic and public company audit reports when either an adverse opinion or a disclaimer of opinion is issued.

Since audit reports are modified for material matters and include a paragraph on such matters, a question arises concerning such a material matter that is also a KAM (CAM). Do the auditors repeat the information in both the additional paragraph describing the reason for the qualification and in the Key (Critical) Audit Matters section?

For nonpublic companies (AU-C 701), when KAMs are being reported upon, a matter leading to a qualified opinion is, by its nature, considered a KAM. The matter is described in the Basis for Qualification section, with mention of it in the KAMs section. For example, when no other KAMs exist, terminology such as the following should be used following the description of the nature of key audit matters:

Key Audit Matters

Except for the matter described in the Basis for Qualified Opinion Section, we have determined that there are no other key audit matters to communicate in our report. Key audit matters are those matters that were communicated with those charged with governance and, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

PCAOB requirements (AS 3105) state that when a qualified opinion is issued, the auditors should consider whether the matter is also a critical audit matter. If that matter is considered a CAM, the auditors must comply with report disclosure requirements for

both qualified opinions and CAMs. The PCAOB standards allow either (1) two separate paragraphs including the required information from each section of the professional standards or (2) inclusion in the paragraph describing the reason for opinion modification, with referral to that matter in the CAMs section. Note, however, that this may not be a very relevant “real world” question as the SEC seldom accepts such modified opinions in filings.

Additional Reporting Issues

Two or More Report Modifications

An audit report may be qualified for two or more matters. For example, an audit report may include a modification for a scope limitation such as inability to obtain sufficient appropriate audit evidence relating to accounts receivable and a departure from generally accepted accounting principles for equipment valuation. The wording of such a report would include the appropriate qualifying language and basis for opinion for both types of qualifications, ordinarily in separate additional paragraphs. The GAAP departure would be handled as in Figure 17.6 for nonpublic and public companies respectively.

When there are several matters requiring the qualification of an opinion, the auditors should consider the cumulative effects of those matters. If the effect involves material and pervasive known misstatements, an adverse opinion would be appropriate, not a qualified opinion.

Reporting on Comparative Financial Statements

LO 17-5

Describe the auditors' responsibilities for reporting on comparative financial statements.

As indicated previously, many companies present with the current year's financial statements comparative financial statements for one or more prior years. When comparative financial statements are presented by the client company, the auditors' report should cover the current year's financial statements as well as those for prior periods that were audited by the firm.

The auditors may express different opinions on the financial statements of different years. In addition, auditors should update their reports for all prior periods presented for comparative purposes. *Updating* the report means either re-expressing the opinion originally issued or, depending upon the circumstances, revising the opinion from that originally issued. A different opinion on the prior-period financial statements may be warranted because new information may have come to light that causes the auditors to alter their original opinion. For example, the client may revise previously issued financial statements to correct a departure from GAAP, resulting in a situation in which a qualified opinion is no longer warranted. The updated audit report will be unmodified (unqualified) and include an other-matter paragraph describing the circumstances. In the case of a nonpublic company, the paragraph is placed at a point the auditors consider appropriate after the basis for opinion paragraph, while in a public company audit report, the paragraph is placed immediately following the opinion paragraph.

In some situations, the current auditors have not audited the prior-period financial statements because those financial statements are either unaudited or audited by predecessor auditors. If the financial statements of prior comparative periods are unaudited, this fact should be indicated on the applicable financial statements and the auditors' report should include a disclaimer of opinion on those statements. If the prior-period financial statements were audited by predecessor auditors, the current (successor) auditors' *opinion* will cover only the period or periods that they have audited. For the financial statements audited by the predecessor auditors, there are two reporting options. First, the report of the predecessor auditors may be *reissued* by them bearing its original date. Before reissuing the report, the predecessor auditors should read the subsequent period financial statements, compare them with the prior-period financial statements, and obtain representation letters from both management and the successor auditors in essence indicating that they are not aware of information that would indicate that the financial statements are incorrect or improper. The second reporting option is to have the successor auditors *refer to the report of the predecessor auditors*. In a nonpublic company audit report, an Other-Matter section is

added at an appropriate point following the Basis for Opinion paragraph, and in a public company audit report, a paragraph is added to the Opinion section.¹⁸

Reports to the SEC

Most publicly owned corporations are subject to the financial reporting requirements of the federal securities laws, administered by the Securities and Exchange Commission (SEC). Many of the reports, or *forms*, filed with the SEC include audited financial statements for one or more years. Among the most important of these forms are the following:

- *Forms S-1 through S-11*. These are the “registration statements” for companies planning to issue securities to the public.
- *Forms SB-1 and SB-2*. These are more simplified registration forms for small businesses.
- *Form 8-K*. This is a “current report” filed for any time in which significant events occur for a company subject to the Securities Exchange Act of 1934. If the significant event is a business combination, audited financial statements of the acquired company often are required in the current report. An 8-K report also is used to notify the SEC of a change in auditors.
- *Form 10-Q*. This form is filed quarterly with the SEC by publicly owned companies. It contains unaudited financial information. The company’s auditors perform reviews of this information, but their work is substantially less in scope than an audit.
- *Form 10-K*. This report is filed annually with the SEC by publicly owned companies. The report includes audited financial statements and other detailed financial information. It also includes management and the auditors’ reports on internal controls over financial reporting.

Auditors dealing with these reports should be well versed on the requirements of each form, as well as in the provisions of the SEC’s Regulation S-X, which governs the form and content of financial statements filed with the various forms.

The SEC, in conjunction with the Public Company Accounting Oversight Board, has the power to enforce a high-quality performance by auditors of issuers (public companies). The federal securities laws provide both civil and criminal penalties for any person, including auditors, responsible for misrepresentations of fact in audited statements filed with the SEC. The auditors’ legal liability under the federal securities acts is discussed in Chapter 4.

Chapter Summary

This chapter presented the different types of reports that auditors issue to describe the nature of their audit and the resulting opinion provided. To summarize:

1. Audit reports discussed in this chapter include both those with unmodified opinions (unqualified, per PCAOB standards) and those with modified opinions. A report with an unmodified opinion may include presentation of additional information that does not affect the opinion (e.g., a change in accounting principles). The three types of modified opinions are qualified, adverse, and disclaimer of opinion.
2. An unmodified nonpublic company audit report includes a title with the word *independent* and ordinarily is addressed to the organization whose financial statements are being audited or to its board of directors or stockholders and includes the address of the addressee. The report begins with the Opinion and Basis for Opinion sections, followed by other sections, including sections describing management and auditor

¹⁸ In some circumstances, restriction of particular reports issued by the auditors is required. As we discussed in Chapter 7, two reports arising from an audit, communicating internal control–related matters and the auditors’ communication with those charged with governance, result in reports alerting readers as to intended use. Also, as discussed in Chapter 19, agreed-upon procedures engagements and audits of special-purpose financial statements prepared in accordance with a contractual or regulatory basis of accounting must be restricted.

responsibilities. If the auditor is engaged to report on key audit matters (either by decision of the client or as required by law or regulation), the report also includes such a section. If the audit report is included in an annual report, an Other Information section is added to describe the auditors' responsibilities regarding the other information. The order of the paragraphs following the Basis for Opinion section may be decided by the auditors, and the report concludes with the firm signature, location, and audit report date.

3. An unqualified public company audit report includes a heading with the title "Report of Independent Registered Public Accounting Firm" and must be addressed to the shareholders and board of directors, although it may also be addressed to others. It includes an Opinion section, followed by a Basis for Opinion section, and a Critical Audit Matters (CAM) section. When internal control over financial reporting has also been audited (i.e., an integrated audit has been performed), the Opinion section includes a paragraph referring to the audit report on internal control; alternatively, both the audit reports on the financial statements and on internal control of a public company may be combined into one report. While both the public and nonpublic company reports include the firm signature, location, and audit report date, the public company report also includes the year in which the auditors began serving consecutively as the company's auditors. The name of the engagement partner may be included in the report itself (as a separate section), but ordinarily is not; the engagement partner's name is included in a Form AP filed with the PCAOB.
4. Audit reports with unmodified (unqualified) opinions are required to include references to certain matters (e.g., a lack of consistency in accounting principles). In other situations, such reports may, at the auditors' discretion, include particular information relating to the financial statements (e.g., unusually important subsequent events). Figure 17.3 summarizes the effects on audit reports of various circumstances.
5. A Going Concern section must be added to a report with an unmodified (unqualified) opinion when there is substantial doubt about a client's ability to continue as a going concern.
6. Audit reports with unmodified (unqualified) opinions may emphasize a matter that is not described in the audited financial statements. These paragraphs refer to matters that are relevant to users' understanding of the audit, the auditors' responsibilities, or the auditors' report. They typically refer to matters such as when the financial statements of a nonpublic company are included in an annual report, and in audits in which multiple audit firms are involved (a group audit report).
7. Modified opinions are issued when material departures from GAAP or material scope limitations exist. Figure 17.5 provides details on the appropriate modifications for each of these types of reports. Figures 17.6 and 17.7 summarize placement of report modifications.
8. When a client presents comparative financial statements for one or more prior periods with the current-period financial statements, the auditors should make certain that all periods are covered by an audit report. Audit reports on prior periods should be updated based on any new information that might affect the auditors' opinion. When predecessor auditors have audited the prior-period financial statements, the current (successor) auditors may summarize the predecessor auditors' opinion in the current-year audit report or the client may arrange to have the predecessor auditors reissue their audit report.
9. Auditors of publicly held corporations should understand the various reporting requirements of the SEC. The reports filed with the SEC must be in accordance with Regulation S-X, which governs the form and content of the corporation's financial statements.

Key Terms Introduced or Emphasized in Chapter 17

Adverse opinion (786) An opinion that the financial statements *do not* fairly present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. This situation occurs when the auditors believe that departures from GAAP are both material and pervasive.

Change in accounting principle (786, 792) Changes in accounting principles and reporting entities result in an emphasis-of-matter paragraph being added to the auditors' report.

Comparative financial statements (775) A complete set of financial statements for one or more prior periods included for comparison with the financial statements of the current period.

Component (of a financial statement) (794) An entity or business activity for which group or component management prepares financial information that is required by the applicable financial reporting framework to be included in group financial statements.

Component auditor (795) Under AICPA standards, an auditor who performs audit work related to a component for purposes of the group audit. A component auditor is a part of the engagement team for a group audit. The term "other auditor" is used in PCAOB standards.

Critical audit matter (CAM) (779, 781) As included in the PCAOB auditing standards, a matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment.

Disclaimer of opinion (787) A form of report in which the auditors state that they do not express an opinion on the financial statements.

Emphasis of a matter paragraph (787) A paragraph inserted in an audit report issued under PCAOB standards to describe certain circumstances that the auditors believe should be emphasized (e.g., uncertainties, unusually important subsequent events, a major catastrophe, a division of responsibility for the total audit). See also explanatory paragraph.

Emphasis-of-matter paragraph (787) A section (paragraph) included in the nonpublic company auditors' report that is required by GAAS or is included at the auditors' discretion, and that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditors' judgment, is of such importance that it is fundamental to users' understanding of the financial statements (e.g., a lack of consistent application of GAAP). For public companies, as discussed in detail in Chapter 17, the terms *explanatory paragraph* and *emphasis-of-a-matter paragraph* are used.

Engagement team (795) All partners and staff performing the audit engagement, and any other individuals who perform audit procedures on the engagement, excluding an auditor's external specialist and internal auditors who provide direct assistance on an engagement. (When component auditors are involved in a group audit, they are considered part of the engagement team.)

Explanatory paragraph (787) A paragraph inserted in an auditors' report issued under PCAOB standards to describe a matter relating to the financial statements or to the audit. Also see emphasis of a matter paragraph. AICPA Auditing Standards Board (and international) standards use the terms "emphasis-of-matter paragraph" and "other-matter paragraph."

Form AP (784) The PCAOB form that requires (1) the name of the engagement partner; (2) the names, locations, and extent of participation of other accounting firms that took part in the audit if their work constituted 5 percent or more of total audit hours; and (3) the number and aggregate extent of participation of other accounting firms that took part in the audit.

General-purpose financial reporting framework (775) A financial reporting framework designed to meet the common financial information needs of a wide range of users.

Group audit (795) The audit of the financial statements of a company composed of more than one component.

Group auditors (794) The group engagement partner and members of the engagement team other than component auditors. PCAOB standards refer to the group auditor as the lead auditor and also include the firm itself in that definition.

Group engagement partner (795) The engagement partner responsible for the group audit.

Group financial statements (794) Financial statements that include the financial information of more than one entity or business unit through a consolidation process.

Key audit matter (KAM) (778) As included in the AICPA and international auditing standards, matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated to those charged with governance.

Material (786) Being of substantial importance. Significant enough to affect evaluations or decisions by users of financial statements. Information that should be disclosed in order for the financial statements to constitute a fair presentation. Determining what is material involves both quantitative and qualitative criteria.

Modified opinion (786) A qualified opinion, an adverse opinion, or a disclaimer of opinion.

Other information (778) Financial and nonfinancial information (other than the financial statements and the auditors' report thereon) included in an entity's annual report.

Other-matter paragraph (787) This term is used in nonpublic auditing standards for a paragraph (section) included in the auditors' report that is required by GAAS, or is included at the auditor's discretion and that refers to a matter other than those presented or disclosed in the financial statements. Public company auditing standards consider these paragraphs (sections) as one type of explanatory paragraph.

Pervasive (786) A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditors' judgment, • Are not confined to specific elements, accounts, or items of the financial statements. • If confined, represent or could represent a substantial proportion of the financial statements. • In relation to disclosures, are fundamental to users' understanding of the financial statements.

Qualified opinion (786) A modification of the auditors' opinion employing a clause such as *except for* to limit the auditors' opinion on the financial statements. A qualified opinion indicates that, except for the effects of some limitation on the scope of the audit or some departure from generally accepted accounting principles, the financial statements are fairly presented.

Reasonable period of time (788) The period of time required by the applicable financial reporting framework or, if no requirement exists, within one year after the date the financial statements are issued (or available to be issued). **(relating to a client's going concern status)**

Referred-to auditor (795) An auditor who performs an audit of the financial statements of a component to which the group engagement partner determines to make reference in the auditor's report on the group financial statements. A referred-to auditor is not a component auditor and, accordingly, is not a part of the engagement team for a group audit.

Scope limitation (786) A restriction that prevents the auditors from being able to apply all of the audit procedures that they consider necessary in the circumstances. Scope limitations may be client imposed or may be imposed by other circumstances.

Significant Risks (779) Identified and assessed risks of material misstatement that, in the auditor's judgment, require special audit consideration.

Standard report (775) An audit report with (1) an unmodified (unqualified) opinion and (2) no additional matters emphasized (e.g., a change in accounting principles) beyond the information required in audit reports. Note that while this term is frequently used in practice, neither the AICPA nor the PCAOB currently uses it in its standards.

Substantial doubt (788) When relevant conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued (or available to be issued). **(about an entity's ability to continue as a going concern)**

Unmodified opinion (786) For nonpublic companies, the opinion expressed by the auditors when they conclude that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework (e.g., GAAP).

Unqualified opinion (786) For public companies, the opinion expressed when they conclude that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework (e.g., GAAP).

Review Questions

- 17-1. Comment on whether you agree with the following, and why: An audit report on comparative financial statements ordinarily compares current-year financial statements of two or more companies with one another.
- 17-2. What is the function of notes to financial statements?
- 17-3. To which individuals and/or organizations is a public company audit report ordinarily addressed?
- 17-4. Comment on whether you agree with the following and why: GAAP and GAAS represent two frequently used financial reporting frameworks.

- 17-5. Provide a list of the types of nonpublic company unmodified and modified audit opinions.
- 17-6. What information is provided in a public company audit report relating to critical audit matters?
- 17-7. Howard Green, a partner with Cary, Loeb, & Co., and his audit team have completed the audit of Baker Manufacturing. Determine the proper date of the audit report.
 - December 31, 20X0: Baker's year-end.
 - February 15, 20X1: Green completed audit procedures performed at Baker's location.
 - February 19, 20X1: The financial statements were completed.
 - February 20, 20X1: All audit procedures were completed, including the review of all audit documentation.
 - February 25, 20X1: Green signed the audit report.
 - February 26, 20X1: Green delivered the audit report to Baker.
- 17-8. When the current auditors make reference to the work of the referred-to auditors, does this result in expression of a qualified opinion? Explain.
- 17-9. Explain three situations in which the wording of a report with an unmodified opinion might be modified, yet the opinion remains unmodified.
- 17-10. Wade Corporation has been your audit client for several years. At the beginning of the current year, the company changed its method of inventory valuation from average cost to last-in, first-out (LIFO). The change, which had been under consideration for some time, was in your opinion a logical and proper step for the company to take. What effect, if any, will this situation have on your audit report for the current year?
- 17-11. What are the two circumstances that result in modified opinions?
- 17-12. Comment on the following: "If the financial statements contain an immaterial departure from generally accepted accounting principles, the auditors issue a qualified opinion; if the financial statements contain a material departure from GAAP, the auditors issue an adverse opinion."
- 17-13. What factors determine whether a misstatement is considered *pervasive*?
- 17-14. Can the client change a set of financial statements to receive an unmodified opinion instead of an opinion qualified as to the adequacy of disclosure? Explain.
- 17-15. Describe the alterations from the unmodified report of a nonpublic company when a scope limitation has occurred and the auditors have issued a qualified opinion.
- 17-16. Because of a very significant scope limitation, the auditors are uncertain about the propriety of the client's accounting for deferred income taxes. The possible amounts involved are so significant that the auditors have not been able to form an opinion on the financial statements taken as a whole. What type of report should they issue?
- 17-17. Why are adverse opinions rare?
- 17-18. Comment on whether you agree with the following: In a nonpublic company audit report, the second section is always titled "Basis for Opinion."
- 17-19. Assume that CPAs are attesting to comparative financial statements. Can the CPAs express differing opinions on the sets of financial statements of two successive years?
- 17-20. Assume that CPAs are attesting to comparative financial statements. Can the CPAs change their report on the prior year's statements?
- 17-21. Describe the reports containing audited financial statements that are customarily filed by a company subject to the reporting requirements of the SEC.

Questions

Requiring LO 17-1, Analysis 2

Select questions are available with Connect.



- 17-22. An accountant of an audit client made the following statement: It is important to read the notes to financial statements, even though they are presented in technical language and are incomprehensible. Auditors may reduce their exposure to third-party liability by stating something in the notes that contradicts completely what the client has presented in the balance sheet or income statement.
Evaluate the above statement and indicate
 - a. Areas of agreement, if any.
 - b. Areas of misconception, incompleteness, or fallacious reasoning included in the statement.

- LO 17-3** 17–23. Rowe & Myers audits the financial statements of Dunbar Electronics. During the audit, Rowe & Myers engaged Jones & Abbot, a Canadian public accounting firm, to audit Dunbar's wholly owned Canadian subsidiary. Jones & Abbot will be treated as a component auditor.
- Assume that Rowe & Myers will issue an audit report with an unmodified opinion and no other financial statement information included. Should Rowe & Myers make reference to the component auditor in its audit report? Explain.
 - Assume that Jones & Abbott issued a qualified report on the Canadian subsidiary. Should Rowe & Myers include the same qualification in its report on Dunbar Electronics?
- LO 17-3** 17–24. Lando Corporation is a nonpublic domestic company with two wholly owned domestic subsidiaries. Michaels, CPA, has been engaged to audit the financial statements of the parent company and one of the subsidiaries and will act as the group auditor. Thomas, CPA, will audit the financial statements of the other subsidiary. Michaels has not yet decided whether to treat Thomas as a component auditor or a referred-to auditor.
- What audit procedures should Michaels perform with respect to the other auditor, regardless of whether Michaels decides to treat Thomas as a component auditor or a referred-to auditor?
 - Briefly compare the modifications made to the audit report if Michaels decides to treat Thomas as a component auditor versus a referred-to auditor.
- LO 17-3** 17–25. While performing your audit of Williams Paper Company, you discover evidence that indicates that Williams may not have the ability to continue as a going concern.
- Discuss types of information that may indicate substantial doubt about a client's ability to remain a going concern.
 - Explain the auditors' obligation in such situations.

Objective Questions

- LO 17-4** 17–26. **Multiple Choice Questions**
- A material departure from generally accepted accounting principles will result in auditor consideration of:
 - Whether to issue an adverse opinion rather than a disclaimer of opinion.
 - Whether to issue a disclaimer of opinion rather than a qualified opinion.
 - Whether to issue an adverse opinion rather than a qualified opinion.
 - Nothing, because none of these opinions is applicable to this type of exception.
- LO 17-1, 2**
- The auditors' report should be dated as of the date the:
 - Report is delivered to the client.
 - Auditors have accumulated sufficient appropriate evidence.
 - Fiscal period under audit ends.
 - Peer review of the working papers is completed.
- LO 17-3**
- In an audit report on combined financial statements, reference to the fact that a portion of the audit was performed by a referred-to auditor is:
 - Not to be construed as a qualification, but rather as a division of responsibility between the two CPA firms.
 - Not in accordance with generally accepted auditing standards.
 - A qualification that lessens the collective responsibility of both CPA firms.
 - An example of a dual opinion requiring the signatures of both auditors.
- LO 17-1, 2**
- Assume that the opinion paragraph of an auditors' report begins as follows: "With the explanation given in Note 6, . . . the financial statements referred to above present fairly . . ." This is:
 - An unmodified opinion.
 - A disclaimer of opinion.
 - An "except for" opinion.
 - An improper type of reporting.

LO 17-3

e. The auditors who wish to draw reader attention to a financial statement note disclosure on significant transactions with related parties should disclose this fact in:

- (1) An emphasis-of-matter paragraph to the auditors' report.
- (2) A footnote to the financial statements.
- (3) The body of the financial statements.
- (4) The "Summary of Significant Accounting Policies" section of the financial statements.

LO 17-4

f. What type or types of audit opinion are appropriate when financial statements are materially and pervasively misstated?

	Qualified	Adverse
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

LO 17-3

g. Critical audit matters are most likely to include those matters that:

- (1) Are communicated to the Public Company Accounting Oversight Board.
- (2) Involve challenging, subjective, or complex auditor judgment.
- (3) Are material weaknesses in internal control.
- (4) Involve significant risks.

LO 17-2

h. An audit report for a public client indicates that the audit was performed in accordance with:

- (1) Generally accepted auditing standards (United States).
- (2) Standards of the Public Company Accounting Oversight Board (United States).
- (3) Generally accepted accounting principles (United States).
- (4) Generally accepted accounting principles (Public Company Accounting Oversight Board).

LO 17-2

i. An audit report for a public client indicates that the financial statements were prepared in conformity with:

- (1) Generally accepted auditing standards (United States).
- (2) Standards of the Public Company Accounting Oversight Board (United States).
- (3) Generally accepted accounting principles (United States).
- (4) Generally accepted accounting principles (Public Company Accounting Oversight Board).

LO 17-3

j. When the matter is properly disclosed in the financial statements of a nonpublic company, the likely result of substantial doubt about the ability of the client to continue as a going concern is the issuance of which of the following audit opinions?

	Qualified	Unmodified with an Additional Paragraph
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

LO 17-4

k. A nonpublic company's change in accounting principles that the auditors believe is not justified is likely to result in which of the following types of audit opinions?

	Qualified	Unmodified with Emphasis-of-Matter
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

LO 17-3

l. Which of the following is *least* likely to result in an additional paragraph being added to an audit report?

- (1) The company is a component of a larger business enterprise.
- (2) An unusually important significant event.
- (3) A decision not to confirm accounts receivable.
- (4) A risk or uncertainty.

LO 17-3, 4

17–27. For each of the following brief scenarios, assume that you are reporting on a client's financial statements. Reply as to the type(s) of opinion possible for the scenario. In addition:

- Unless stated otherwise, assume the matter involved is material.
- If the problem does not state that a misstatement (or possible misstatement) is pervasive, assume that it may or may not be pervasive (thus, the appropriate reply may include two possible reports).
- Do not read more into the circumstance than what is presented.

Do not consider an auditor discretionary circumstance for modification of the audit report unless the situation explicitly suggests that the auditors wish to emphasize a particular matter. Report Types may be used once, more than once, or not at all.

Situation	Report Types
a. Bowles Company is engaged in a hazardous trade and has obtained insurance coverage related to the hazard. Although the likelihood is remote, a material portion of the company's assets could be destroyed by a serious accident.	1. Unmodified 2. Unmodified with an additional paragraph
b. Draves Company owns substantial properties that have appreciated significantly in value since the date of purchase. The properties were appraised and are reported in the balance sheet at the appraised values (which materially exceed costs) with related disclosures. The CPAs believe that the appraised values reported in the balance sheet reasonably estimate the assets' current values.	3. Qualified 4. Adverse 5. Disclaimer
c. During the audit of Eagle Company, the CPA firm has encountered a significant scope limitation relating to inventory record availability and is unable to obtain sufficient appropriate audit evidence in that area.	6. Either qualified or adverse 7. Either qualified or disclaimer
d. London Company has material investments in stocks of subsidiary companies. Stocks of the subsidiary companies are not actively traded in the market, and the CPA firm's engagement does not extend to any subsidiary company. The CPA firm is able to determine that all investments are carried at original cost but has no real idea of market value. Although the difference between cost and market could be material, it could not have a pervasive effect on the overall financial statements.	8. Either adverse or disclaimer
e. Slade Company has material investments in stocks of subsidiary companies. Stocks of the subsidiary companies are actively traded in the market. Management insists that all investments be carried at original costs, and the CPA firm is satisfied that the original costs are accurate. The CPA firm believes that the client will never ultimately realize a substantial portion of the investments because the market value is much lower than the cost; the client has fully disclosed the facts in notes to the financial statements.	

LO 17-3, 4

17–28. Use the following to provide the type of audit report the auditors generally should issue in the situations presented below:

1. Unmodified (unqualified)—standard.
2. Unmodified (unqualified)—with an additional section (paragraph) (e.g., Emphasis of Matter, Explanatory).
3. Qualified.
4. Adverse.
5. Disclaimer

Situation:

- a. Client-imposed restrictions significantly limit the scope of the auditors' procedures, and they are unable to obtain sufficient appropriate audit evidence. The possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.
- b. The auditors decide to treat another audit firm involved in the audit (of a subsidiary) as a component auditor that audited a portion of group financial statements. That auditor issued a report with a standard unmodified opinion.

- c. The auditors believe that the financial statements have been presented in conformity with generally accepted accounting principles in all respects, except that a loss contingency that should be disclosed through a note to the financial statements is not included. While they consider this a material omission, they do not believe that it pervasively affects the financial statements.
- d. The client has changed from LIFO to FIFO for inventory valuation purposes; the auditors concur with this change. The effect is considered material to the financial statements, although inventory is not a large part of total assets.
- e. The client has changed from LIFO to FIFO for inventory valuation purposes; the auditors do not concur with this change. The effect is considered material and pervasive.

LO 17-3 17–29. Auditors report on the consistency of application of accounting principles. Assume that the following list describes changes that have a material effect on a client's financial statements for the current year.

1. A change from the completed-contract method to the percentage-of-completion method of accounting for long-term construction contracts.
2. A change in the estimated service lives of previously recorded plant assets based on newly acquired information.
3. Correction of a mathematical error in inventory pricing made in a prior period.
4. A change from direct costing to full absorption costing for inventory valuation.
5. A change from deferring and amortizing preproduction costs to recording such costs as an expense when incurred because future benefits of the costs have become doubtful. The new accounting method was adopted in recognition of the change in estimated future benefits.
6. A change to including the employer's share of FICA taxes as "Retirement benefits" on the income statement. This information was previously included with "Other taxes."
7. A change from the FIFO method of inventory pricing to the LIFO method of inventory pricing.

For each of the above situations, state whether the audit report should include an emphasis-of-matter (explanatory) paragraph on consistency.

LO 17-1, 2 17–30. Public company audit reports generally include a section on critical audit matters. For each of the following statements, indicate whether you believe the statement is correct or incorrect. For those you consider incorrect, indicate why.

1. All significant risks identified in an audit constitute critical audit matters.
2. A Critical Audit Matters section follows at an appropriate point after the Basis for Opinion section in an audit report.
3. Critical audit matters are selected from matters communicated to those charged with governance.
4. Critical audit matters are not included in public company audit reports with qualified opinions.
5. In addition to being included in audit reports, critical audit matters are communicated to the PCAOB.
6. When comparative financial statements are presented, the Critical Audit Matters section must include those matters for all years of audited financial statements included.
7. All matters communicated to those charged with governance of a public company are critical audit matters.
8. Not all material weaknesses in internal control are also critical audit matters.
9. When no critical audit matters are identified in an audit, there will be no Critical Audit Matters section in a public company audit report.
10. Critical Audit Matters sections are not included in audit reports with an adverse opinion or a disclaimer of opinion.

LO 17-3, 4 17–31. **Simulation**

Items 1 through 5 present various independent factual situations an auditor might encounter in conducting an audit of a nonpublic company. For each situation, assume:

- The auditor is independent.
- The auditor previously expressed an unmodified opinion on the prior year's financial statements.

- The nonpublic audit client is presenting single-year (not comparative) financial statements.
 - The conditions for an unmodified opinion exist unless contradicted in the factual situations.
 - The conditions stated in the factual situations are material.
 - No report modifications are to be made except in response to the factual situation.
 - The Report Alteration part of the problem only addresses the need to add an additional section or a paragraph to an existing section. Other parts of the audit report may be affected that are not examined in this question.
1. In auditing the long-term investments account, an auditor is unable to obtain audited financial statements for an investee located in a foreign country. The auditor concludes that sufficient appropriate audit evidence regarding this investment cannot be obtained.
 2. Due to recurring operating losses and working capital deficiencies, an auditor has substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. However, the financial statement disclosures concerning these matters are adequate. The auditor has decided *not* to issue a disclaimer of opinion.
 3. A group auditor decides to treat a CPA who audited a wholly owned subsidiary of the entity and issued an unmodified opinion as a component auditor. The total assets and revenues of the subsidiary represent 17 percent and 18 percent, respectively, of the total assets and revenues of the entity being audited.
 4. An entity changes its depreciation method for production equipment from straight-line to a units-of-production method based on hours of utilization. The auditor concurs with the change, although it has a material effect on the comparability of the entity's financial statements.
 5. An entity discloses certain lease obligations in the notes to the financial statements. The auditor believes that the failure to capitalize these leases is a departure from generally accepted accounting principles and, although the possible effects on the financial statements of the misstatements are material, they could not be pervasive.

Below are the types of opinions the auditor ordinarily would issue and report modifications (if any) relating to an additional paragraph or section that would be necessary.

- a. Select as the best answer for each situation (items 1 through 5) the type of opinion and alterations, if any, the auditor would normally select. Replies may be selected once, more than once, or not at all. Assume that a nonpublic company is involved.
- b. Now assume that the company involved is public. While the type of opinion doesn't change, some report alterations may change. For each situation (items 1 through 5) provide the report alteration under PCAOB standards for audits of public companies.

(AICPA, adapted)

Types of Opinions	Report Alteration
a. Unmodified	h. Add a section preceding the Opinion section.
b. Qualified	i. Add a section immediately following the Opinion section.
c. Adverse	j. Add a section at a point following the Basis for Opinion section.
d. Disclaimer	k. Add a paragraph to the Opinion section.
e. Qualified or adverse	l. Add a paragraph to the Basis for Opinion section.
f. Qualified or disclaimer	m. Issue unmodified report without alteration.
g. Disclaimer or adverse	

LO 17-3, 4, 5 17–32. Simulation*

For each of the following brief scenarios, assume that you are reporting on a client's financial statements. Reply as to the type(s) of opinion (per below) possible for the scenario. In addition:

- Unless stated otherwise, assume the matter involved is material. If the problem doesn't tell you whether a misstatement *pervasively* misstates the financial statements or doesn't list a characteristic that indicates pervasiveness, two reports may be possible (i.e., replies 6–9).

* Note that this simulation has more parts than one would expect in a particular CPA exam simulation. We present it to provide examples of many types of reporting situations in one problem.

- Do not read more into the circumstances than what is presented.
- Do not consider an auditor discretionary circumstance for modification of the audit report unless the situation explicitly suggests that the auditor wishes to emphasize a particular matter.

Types of Opinion

1. Unmodified.
2. Unmodified with some modification of the report (e.g., emphasis-of-matter, other-matter, explanatory, other wording).
3. Qualified.
4. Adverse.
5. Disclaimer.
6. Qualified or adverse.
7. Qualified or disclaimer.
8. Adverse or disclaimer.
9. Other

Situation	Report
1. A company has not followed generally accepted accounting principles in the recording of its leases.	
2. A company has not followed generally accepted accounting principles in the recording of its leases. The amounts involved are immaterial.	
3. A company valued its inventory at current replacement cost. Although the auditor believes that the inventory costs do approximate replacement costs, these costs do not approximate any GAAP inventory valuation method.	
4. A client changed its depreciation method for production equipment from the straight-line method to the units-of-production method based on hours of utilization. The auditor concurs with the change.	
5. A client changed its depreciation method for production equipment from the straight-line to a units-of-production method based on hours of utilization. The auditor does not concur with the change.	
6. A client changed the depreciable life of certain assets from 10 years to 12 years. The auditor concurs with the change.	
7. A client changed the depreciable life of certain assets from 10 years to 12 years. The auditor does not concur with the change. Confined to fixed assets and accumulated depreciation, the misstatements involved are not considered pervasive.	
8. A client changed the method it uses to calculate postemployment benefits from one acceptable method to another. The effect of the change is immaterial this year but is expected to be material in the future.	
9. A client changed the salvage value of certain assets from 5 percent to 10 percent of original cost. The auditor concurs with the change.	
10. A client uses the specific identification method of accounting for valuable items in inventory, and LIFO for less valuable items. The auditor concurs that this is a reasonable practice.	
11. Due to recurring operating losses and working capital deficiencies, an auditor has substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. The notes to the financial statements adequately disclose the situation. The auditor has decided not to issue a disclaimer of opinion.	
12. Due to recurring operating losses and working capital deficiencies, an auditor has substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. The notes to the financial statements do not adequately disclose the substantial doubt situation, and the auditor believes the omission fundamentally affects the users' understanding of the financial statements.	
13. A group auditor decides to treat the work of another auditor involved in the overall group audit as that of a component auditor. That component auditor audited a 70 percent owned subsidiary and issued an unmodified opinion. The total assets and revenues of the subsidiary are 5 percent and 8 percent, respectively, of the total assets and revenues of the entity being audited.	
14. A group auditor decides to treat the work of another auditor involved in the overall group audit as that of a "referred-to" auditor. That referred-to auditor audited a 70 percent owned subsidiary and issued an unmodified opinion. The total assets and revenues of the subsidiary are 5 percent and 8 percent, respectively, of the total assets and revenues of the entity being audited.	
15. An auditor was hired after year-end and was unable to observe the counting of the year-end inventory. She is unable to apply other procedures to determine whether ending inventory and related information are properly stated.	

Situation	Report
16. An auditor was hired after year-end and was unable to observe the counting of the year-end inventory. However, she was able to apply other procedures and determined that ending inventory and related information are properly stated. 17. An auditor discovered that a client made illegal political payoffs to a candidate for president of the United States. The auditor was unable to determine the amounts associated with the payoffs because of the client's inadequate record-retention policies. The client has added a note to the financial statements to describe the illegal payments and has stated that the amounts of the payments are not determinable. 18. An auditor discovered that a client made illegal political payoffs to a candidate for president of the United States. The auditor was unable to determine the amounts associated with the payoffs because of the client's inadequate record-retention policies. Although there is no likelihood that the financial statements are pervasively misstated, they may be materially misstated. The client refuses to disclose the payoffs in a note to the financial statements. 19. In auditing the long-term investments account of a new client, an auditor finds that a large contingent liability exists that is material to the consolidated company. It is probable that this contingent liability will be resolved with a material loss in the future, but the amount is not estimable. Although no adjusting entry has been made, the client has provided a note to the financial statements that describes the matter in detail. 20. In auditing the long-term investments account of a new client, an auditor finds that a large contingent liability exists that is material to the consolidated company. It is probable that this contingent liability will be resolved with a material loss in the future, and this amount is reasonably estimable as \$2,000,000. Although no adjusting entry has been made, the client has provided a note to the financial statements that describes the matter in detail and includes the \$2,000,000 estimate in that note. 21. A client is issuing two years of comparative financial statements. The first year was audited by another auditor who is <i>not</i> being asked to reissue her audit report. (Reply as to the successor auditors' report.) 22. A client is issuing two years of comparative financial statements. The first year was audited by another auditor who is being asked to reissue her audit report. (Reply as to the successor auditors' report.) 23. A client's financial statements follow GAAP, but the auditor wishes to emphasize in his audit report a significant related party transaction that is adequately described in the notes to the financial statements. 24. A client's financial statements follow GAAP except that they do not include a note on a significant related party transaction. 25. During the audit of a public company, the auditors identified a critical audit matter. Sufficient appropriate audit evidence was gathered to indicate the related account was properly stated. The audit report to be issued includes a Critical Audit Matters section that properly describes the matter. Reply as to additional modifications required.	

LO 17-3, 4 17–33. **Simulation**

Johnson & Barkley, CPAs, audited the consolidated financial statements of Jordan Company (a public company) for the year ended December 31, 20X7.

Johnson & Barkley previously have audited and issued unqualified audit reports on Jordan Company's financial statements for the preceding 7 years (beginning in 20X0). The 20X7 consolidated financial statements are being presented on a comparative basis (two years for the balance sheet, three years for the other statements) and an unqualified opinion is being expressed. Smith, the engagement supervisor, instructed Abler, an assistant on the engagement, to draft the auditors' report. In drafting the report below, Abler considered the following:

- Jordan changed its method of accounting for inventory from LIFO to FIFO in 20X7.

Report of Independent Registered Public Accounting Firm (Point 1)
To Jordan Company and its shareholders (Point 2)

Opinion on the Financial Statements

We have audited the accompanying balance sheets of Jordan Company (the "Company") as of December 31, 20X7 and 20X6, the related statements of income, comprehensive income, stockholders' equity, and cash flows, for each of the three years in the period ended December 31, 20X7, and

(continued)

the related notes [and schedules] (collectively referred to as the “financial statements”). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 20X7 and 20X6, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X7, in conformity with accounting principles generally accepted in the United States of America. As indicated in the next paragraph, the Company has a change in Accounting Principles in 20X7. (Point 3)

Change in Accounting Principles

As discussed in Note 2 to the consolidated financial statements, the Company adopted the first-in-first-out method of inventory valuation in 20X7. (Point 4)

Basis for Opinion

(Point 5) Our responsibility is to express an opinion on the Company’s financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB. We conducted our audits in accordance with the standards of the PCAOB. (Point 6) Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matters (Point 7)

The critical audit matters communicated below are matters arising from the current period audit of the financial statements that were communicated ~~or~~ required to be communicated to management *(Point 8)* and that (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

[Assume critical audit matters properly described]

Johnson & Barkley, CPAs

We have served as the Company’s auditor since 20X0. (Point 9)

Los Angeles, California

December 31, 20X8 (Point 10)

- Jordan is a defendant in a lawsuit alleging patent infringement. This is adequately disclosed in the notes to Jordan’s financial statements, but no provision for liability has been recorded because the ultimate outcome of the litigation cannot presently be determined.

Abler drafted the following audit report:

Required:

Smith reviewed Abler’s draft and stated in the *Supervisor’s Review Notes* below that there were deficiencies in Abler’s draft. Items 1 through 10 represent the deficiencies noted by Smith. For each deficiency, indicate whether Smith is correct or incorrect in the criticism of Abler’s draft.

1. The report’s title is incorrect as it should not include the word “independent.”
2. The report also must be addressed to the board of directors.
3. The change in accounting principles should not be referred to in the opinion paragraph—delete that sentence.
4. The Change in Accounting Principles paragraph should include the dollar effect of the change.
5. The Basis for Opinion section should begin with a statement that the financial statements are the responsibility of management.
6. The sentence should state generally accepted auditing standards of the PCAOB.

7. When critical matters exist, the two related paragraphs (this and the following paragraph) should immediately follow the opinion paragraph.
8. The point should say communicated to the audit committee.
9. This disclosure also must include the name of the engagement partner.
10. The report should be dated as of February 12, the date on which sufficient appropriate audit evidence was obtained.

17–34. Document Review Simulation

This simulation, available online, presents a draft of a nonpublic company audit report document and three exhibits. To allow this simulation to stand alone without consideration of other parts of the Keystone Computers & Networks, Inc. (Keystone) case, assume that the findings described in this case were identified very late in the audit and that any other misstatements identified in other portions of the case have been corrected. An associate member of the Adams, Barnes & Co. audit team prepared a first draft of the audit report on Keystone's 20X5 financial statements. As the audit senior for this engagement, you will now review and revise the 20X5 audit report for the Keystone audit. Use the additional client information in the Resources tab to revise the draft and correct any errors and remove any inappropriate or unnecessary items, given the overall context and purpose of the list. Ensure that the 20X5 audit report is appropriate given the information provided.

DOCUMENT

Certified Public Accountant's Report (*Callout #1*)

To: Sam Best, President (Callout #2)
Phoenix, Arizona

Qualified Opinion

We have audited the financial statements of Keystone Computers & Networks, Inc. (The Company) which comprise the balance sheets as of December 31, 20X5 and 20X4, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

In our opinion, except for the omission of the information described in the Basis for Qualified Opinion section of our report and subject to the accounting change described in the Emphasis of Matter Paragraph, (*Callout #3*) the accompanying financial statements present fairly, in all material respects, the financial position of The Company as of December 31, 20X5 and 20X4, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Basis for Qualified Opinion

The Company has excluded from property and debt in the accompanying balance sheets certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by \$3,500,000, long-term debt by \$3,500,000, and retained earnings by \$500,000 as of December 31, 20X5. Additionally, net income would be increased by \$500,000 and earnings per share would be increased by \$1.12 for the year then ended. (*Callout #4*)

We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of The Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audit. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified audit opinion.

Emphasis of Matter

As discussed in Note 4 to the financial statements, in 20X5 the entity elected to change the estimated life of a number of its plant assets. We concur with the change. (*Callout #5*)

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

(continued)

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about The Company's ability to continue as a going concern.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for (Callout #6) one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users made on the basis of these financial statements.

In performing an audit in accordance with GAAS, we:

- Use professional judgment and exercise professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of The Company's internal control. Accordingly, no such opinion is expressed.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about The Company's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control related matters identified during our audit.

Adams, Barnes & Co. (Callout #7)

Phoenix, Arizona

February 6, 20X6 (Callout #8)

CALLOUTS

CALLOUT LIST #1

Choose an option below:

- a. [Original text] Certified Public Accountant's Report
- b. [Delete text]
- c. Objective Audit Report
- d. Independent Auditor's Report
- e. Registered Auditor's Report

CALLOUT LIST #2

Choose an option below:

- a. [Original text] Sam Best, President:
- b. [Delete text]
- c. Sam Best, President, and Loren Steele, Controller
- d. Department of Internal Auditing
- e. Audit Committee of Keystone
- f. Board of Directors of Keystone

CALLOUT LIST #3**Choose an option below:**

- a. [Original text] and subject to the accounting change described in the Emphasis of Matter paragraph
- b. [Delete text]
- c. and except for the matter described in the Emphasis of Matter paragraph
- d. and because of the significance of the matter described in the Emphasis of Matter paragraph
- e. and considering the matter described in the Emphasis of Matter paragraph

CALLOUT LIST #4**Choose an option below:**

- a. [Original text] *Basis for Qualified Opinion* The Company has excluded from property and debt in the accompanying balance sheets certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by \$3,500,000, long-term debt by \$3,500,000, and retained earnings by \$500,000 as of December 31, 20X5. Additionally, net income would be increased by \$500,000 and earnings per share would be increased by \$1.12 for the year then ended.
- b. [Delete text]
- c. *Basis for Qualified Opinion* The Company has excluded from property and debt in the accompanying balance sheets certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. Except for these lease obligations, other accounting principles followed are in accordance with accounting principles generally accepted in the United States of America.
- d. Original text, but change title of section to Basis for Disclaimer of Opinion.
- e. Original text, but move section to precede the Qualified Opinion section.

CALLOUT LIST #5**Choose an option below:**

- a. [Original text] As discussed in Note 4 to the financial statements, in 20X5 the entity elected to change the estimated life of a number of its plant assets. We concur with this change.
- b. [Delete entire paragraph]
- c. Delete only final sentence, "We concur with the change."
- d. Add the following at the end of the paragraph: We provide no assurance related to this change.
- e. Add the following at the end of the paragraph: We provide reasonable assurance related to this change.

CALLOUT LIST #6**Choose an option below**

- a. [Original text] higher than for
- b. [Delete text]
- c. lower than for
- d. equal to
- e. approximately twice as high as

CALLOUT LIST #7**Choose an option below:**

- a. [Original text] Adams, Barnes & Co.
- b. [Delete text]
- c. Keystone Engagement Partner (provide partner's name)

- d. Include names of all primary engagement staff and partner members.
- e. Adams, Barnes & Co., LLP, by Keystone Engagement Partner (provide partner's name)

CALLOUT LIST #8*Choose an option below:*

- a. [Original text] February 6, 20X6.
- b. [Delete text]
- c. January 31, 20X6, except for Note 7, as to which the date is February 2, 20X6.
- d. December 31, 20X5.
- e. January 31, 20X6.
- f. February 2, 20X6.

Exhibits

- a. Working Paper Memo
- b. Audit Report Memo
- c. E-mail to Senior

EXHIBIT 1:**Working Paper Memo**

Schedule D-2-3

Plant Assets
Keystone
1/10/X6

Keystone has changed the life of a material portion of its plant assets from 25 years to 28 years. The effect of this change is to materially increase net income. I agree that the change is appropriate. Note 4 discusses the change.

Depreciation Expense based on 25-year life: See Schedule XXX

Depreciation Expense based on 28-year life: See Schedule XXY

Keystone Engagement Partner

EXHIBIT 2:**Audit Report Memo**Memo

To: Senior
From: Keystone Engagement Partner
Date: January 29, 20X6
Re: Audit Report

I spoke with the Chairman of the Board of Directors, as well as the President and the Controller. The overall Board deals with governance of Keystone as the company has not developed an audit committee; the CEO and Controller fulfill traditional roles within the company. All agreed on the following:

- They confirmed that they wish to only present financial statements for the year ended 12/31/20X5.
- I pointed out to them that given our audit findings and circumstances of the engagement, the audit report will include any modifications required by the standards, but no discretionary sections or disclosures.
- I agree that the change in plant asset life is justifiable and preferable.
- Note that the company has not capitalized certain leases, a departure from GAAP. The President and Controller believe that capitalizing the leases would lead to misleading financial statements. I pointed out to them my disagreement, and my belief that not capitalizing the leases materially, but not pervasively, misstates the financial statements. They said they disagree, but that they know that we, as auditors, must "follow the standards."
- The President and Controller agree that they will sign the representations letter as we have prepared it.

EXHIBIT 3:**E-mail to Senior**

To: Senior
 From: Keystone Engagement Partner
 Date: February 4, 20X6
 Re: Revision of Keystone Financial Statements (i.e., Note 9),

I have spoken with the Chairman of the Board of Directors, as well as the President and Controller, concerning note 7 to the financial statements describing the fire in the warehouse on February 2, 20X6.

January 31 was the date on which we had obtained sufficient appropriate audit evidence with respect to the overall financial statements. But, as indicated, the fire occurred on February 2 and resulted in inclusion of an additional note disclosure that includes the date and other details related to the fire. We will follow an approach of limiting our subsequent event procedures solely to the financial statement revisions related to the fire rather than extending all subsequent event procedures and assuming responsibility for all subsequent events.

Assuming we complete necessary audit procedures in time, we should plan on issuing our audit report on February 6.

Problems
 LO 17-1,
 3

- 17-35. Below is a part of the auditors' report drafted by a staff accountant of Williams & Co., CPAs, at the completion of the audit of the financial statements of Lenz Corporation (nonpublic company) for the year ended December 31, 20X1. Assume that there is substantial doubt about the entity's ability to continue as a going concern and that this doubt is properly disclosed in the financial statements.

Emphasis-of-Matter—Going Concern

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations, has a net capital deficiency, and has stated that substantial doubt exists about the Company's ability to continue as a going concern beyond a reasonable period of time. Management's evaluation of the events and conditions and management's plans regarding these matters also are described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty. Our opinion is not modified with respect to this matter.

Opinion

We have audited the financial statements of Lenz Corporation and the related notes to the financial statements.

In our opinion, except for the effects of the matter described in the preceding paragraph, the accompanying financial statements present fairly, in all material respects, the financial position of Lenz Corporation, and the results of its operations and its cash flows for the year then ended, in accordance with accounting principles generally accepted in the United States of America applied on a basis consistent with the preceding year.

Basis for Opinion

We conducted our audit in accordance with accounting standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of Lenz Corporation in accordance with ethical requirements that are relevant to our audit of the financial statements, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

Auditor's Responsibilities for the Audit of the Financial Statements [Assume this section is properly presented]

Responsibilities of Management for the Financial Statements [Assume this section is properly presented]

[Assume report is properly signed and dated.]

Identify deviations from the appropriate nonpublic company audit report.

- LO 17-2** 17–36 The auditors' report that follows was drafted by a staff accountant of Smith & Co., CPAs, at the completion of the audit of the financial statements of Lenses Co. (a public company) for the year ended December 31, 20X7.

Report of Independent Public Accounting Firm

To the Management of Lenses Co.

Opinion on the Financial Statements

We have examined the accompanying balance sheets of Lenses Co. (the "Company") as of December 31, 20X7 and 20X6, the related statements of income, comprehensive income, stockholders' equity, and cash flows, for each of the three years in the period ended December 31, 20X7, and the related notes [and schedules] (collectively referred to as the "financial statements"). In our opinion, the financial statements present, in all material respects, the financial position of the Company as of December 31, 20X7 and 20X6, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X7, in conformity with accounting principles generally accepted in the United States of America applied on a consistent basis.

We also have reviewed, in accordance with standards of the Public Company Accounting Oversight Board (United States) ("PCAOB") the Company's internal control over financial reporting as of December 31, 20X7, based on *Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)* and our report dated February 12, 20X8, and our report expressed an unqualified opinion.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB. We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain positive assurance about whether the financial statements are free of all misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matters

The critical audit matters communicated below are matters arising from the current period audit of the financial statements that were communicated or required to be communicated to the audit committee and that (1) relate to misstatements that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters serves as a second form of assurance on the financial statements, does not alter in any form our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

[You may assume critical audit matters are appropriately presented.]

Williams & Co.

Certified Public Accountants
Los Angeles, California
February 12, 20X8

Identify deviations from the public company unmodified report.

- LO 17-4** 17–37. Sturdy Corporation (a nonpublic company) owns and operates a large office building in a desirable section of New York City's financial center. For many years, management of Sturdy Corporation has modified the presentation of its financial statement by
- Reflecting a write-up to appraisal values in the building accounts.
 - Accounting for depreciation expense on the basis of such valuations.

Wiley, CPA, was asked to audit the financial statements of Sturdy Corporation for the year ended December 31, 20X3. After completing the audit, Wiley concluded that, consistent with prior years, an adverse opinion would have to be expressed because the material misstatements were considered pervasive.

- a. Write a draft of the Opinion section of the auditors' report on the financial statements of Sturdy Corporation for the year ended December 31, 20X3.
- b. Describe in detail the appropriate content of the Basis for Opinion section of the auditors' report on the financial statements of Sturdy Corporation for the year ended December 31, 20X3. You need not draft the section and do not discuss deferred taxes.

LO 17-1, 3, 4 17–38. Roscoe & Jones, Ltd., a CPA firm in Silver Bell, Arizona, has completed the audit of the financial statements of Excelsior Corporation (a public company) as of, and for, the year ended December 31, 20X1. No audit of internal control is required and one has not been performed. Findings related to the financial statements and the audit include

1. Excelsior has been in existence for a number of years and been audited for the past seven years by Roscoe & Jones. It is presenting balance sheets for the two years then ended and statements of income, stockholders' equity, and cash flows for the three years then ended.
2. Roscoe was unable to perform normal accounts receivable confirmation procedures, but alternate procedures were used to satisfy Roscoe as to the validity of the receivables.
3. Excelsior Corporation is the defendant in litigation, the outcome of which is highly uncertain. If the case is settled in favor of the plaintiff, Excelsior will be required to pay a substantial amount of cash that might require the sale of certain assets. The litigation and the possible effects have been properly disclosed in Note 11. Roscoe wishes to include discussion of this matter in the audit report.
4. During 20X1 Excelsior changed its method of accounting for long-term construction contracts and properly reflected the effect of the change. Roscoe is satisfied with Excelsior's justification for making the change. The change is discussed in Note 12.
5. Excelsior issued debentures on January 31, 20X1, in the amount of \$10 million. The funds obtained from the issuance were used to finance the expansion of plant facilities. The debenture agreement restricts the payment of future cash dividends to earnings after December 31, 20X1. Excelsior declined to disclose these data in the notes to the financial statements. Roscoe considers this a material but not pervasive omission.
6. Roscoe gathered sufficient appropriate audit evidence as of February 10, 20X2, and planned a report release date of February 16, 20X2.

For each of points 1 through 6, identify effects on the audit report. You need not draft an audit report.

LO 17-2, 3, 4 17–39. Assume that during the audit of the public Chandler Corporation, the following critical audit matter was identified and summarized for purposes of inclusion in the audit report. Critique presentation and details of the matter.

Critical Audit Matter

The critical audit matter communicated below is a matter arising from the current period audit of the financial statements that was communicated or required to be communicated to the board of directors and that (1) relates to any accounts or disclosures in the financial statements and (2) involved especially complex matters. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are, by communicating the critical audit matter below, providing a separate opinion on the critical audit matters or on the accounts or disclosures to which they relate.

Goodwill

Under generally accepted accounting principles, the company is required to annually test the amount of goodwill for impairment. This annual impairment test was significant to our audit because the balance of \$12,000,000 as of December 31, 20X1, is material to the financial statements. In addition, management's assessment process is complex and highly judgmental and is based on assumptions, specifically [assume assumptions are presented], which are affected by expected future market or economic conditions, particularly those in India and Nepal. Accordingly, we disclaim an opinion on goodwill. The company's disclosures about goodwill are included in Note 6.

In-Class Team Cases

LO 17-3, 17-40
4, 5



For each of the following brief scenarios, assume that you are the CPA reporting on the company's financial statements. Using the form included with this problem, describe the reporting circumstance involved, the type or types of opinion possible in the circumstance, and whether a section should be added to the audit report or whether a paragraph should be added to an existing section. Note that while other report changes may be required, this only addresses the issue of a possible additional section or paragraph being added. Because more than one report may be possible in several of the circumstances, a second "type of opinion" and "report alteration" row is added for each circumstance. For example, if the problem doesn't tell you whether a misstatement *pervasively* misstates the financial statements or doesn't list a characteristic that indicates pervasiveness, two reports may be possible.

In most cases, you will not need to use the second row. Do not read more into the circumstance than what is presented, and only reply "emphasis-of-matter" in auditor discretionary circumstances such as those suggested in the chapter. Unless stated otherwise, assume that the information presented is material to the financial statements. For the report modification, reply for both nonpublic and public audit reports.

Circumstance		Type of Opinion	Report Alteration
GC	Going concern	Unmodified	A Add a section immediately following the opinion section.
CON	Consistency	Qualified	B Add a section at an appropriate point (following Basis for Opinion paragraph for a nonpublic company).
EMPH	Auditor discretionary emphasis-of-matter	Disclaimer	C Add a paragraph to the opinion section.
GROUP	Group audit	Adverse	D Add a paragraph to the basis for opinion section.
GAAP	Departure from GAAP		E Issue an unmodified report without alteration.
SCOPE	Scope limitation		
COMP	Comparative financial statements		
NONE	No circumstance		

1. Your client has declined to depreciate its assets this year because the depreciation expense would reduce the year's small income to a loss.
2. A client's financial statements follow GAAP, but you wish to emphasize that the client is a subsidiary of Webster Corporation in the audit report.
3. In auditing the long-term investments account of a new client, you are unable to obtain audited financial statements for the investee located in a foreign country. You conclude that sufficient appropriate audit evidence regarding this investment cannot be obtained.
4. Due to a very major lawsuit, you have substantial doubt about a client's ability to continue as a going concern for a reasonable period of time; you have decided not to disclaim an opinion. The financial statement disclosures related to this lawsuit are adequate.
5. You decide that it is appropriate to treat other auditors involved as referred-to auditors. The total assets and revenues of the subsidiary are 5 percent and 8 percent, respectively, of the total assets and revenues of the entity being audited.
6. You decide to treat other auditors involved in this audit as component auditors. The total assets and revenues of the subsidiary are 5 percent and 8 percent, respectively, of the total assets and revenues of the entity being audited.
7. A company has changed the remaining life of a significant asset from 12 to 10 years. You believe that the change is reasonable.
8. A company changes from FIFO to LIFO for inventory valuation and you concur with the change. The change has an immaterial effect on the entity's financial statements this year, but it is expected to have a material effect in the future.
9. Your client is a defendant in a major lawsuit. It is probable that the company will experience a material loss due to the lawsuit, although it is impossible to calculate the likely amount. The financial statements include a note adequately describing the matter. You decide that a report with no mention of this matter is inappropriate and a disclaimer of opinion is not necessary.

10. Predecessor auditors audited last year's financial statements and you audited the current year. You have decided not to ask the predecessor to reissue that audit report. Comparative financial statements are being issued on the two years.

	Circumstance	Type Opinion(s)	Nonpublic Company Report	Public Company Report
1.				
2.				
3.				
4.				
5.				
6.				
7.				
8.				
9.				
10.				

LO 17-3, 4, 5 17–41. For each of the following brief scenarios, assume that you are reporting on a client's current-year financial statements. Reply as to the type or types of opinion possible in the circumstance.

- S Unmodified—standard
 U Unmodified with an additional paragraph (e.g., emphasis-of-matter or explanatory)
 Q Qualified
 D Disclaimer
 A Adverse

Because more than one report may be possible in several of the circumstances, a second “opinion” column is added for each circumstance. In certain cases, you will not need to use the second column. Do not read more into the circumstance than what is presented, and do not consider the possibility of an auditors' discretionary emphasis-of-matter paragraph being added to the audit report. Unless stated otherwise, assume that the information presented is material to the financial statements. If the situation doesn't tell you whether a misstatement *pervasively* misstates the financial statements or doesn't list a characteristic that indicates pervasiveness, two reports may be possible.

Situation	Opinion	Opinion
1. A company in its first year of existence values its inventory at current replacement cost. Although you believe that the inventory costs do approximate replacement costs, these costs do not approximate any GAAP inventory valuation method. The difference involved is material, but not pervasively material to the financial statements.		
2. Due to recurring operating losses and working capital deficiencies, you have substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. The notes to the financial statements adequately disclose the substantial doubt situation.		
3. You have discovered that a client made illegal payoffs to a candidate for president of the United States. You are unable to determine the amounts associated with the payoffs because of the client's inadequate record-retention policies. The client has added a note to the financial statements to describe this information and has stated that the amounts of the payments are not determinable.		

(continued)

Situation	Opinion	Opinion
4. In auditing the long-term investments account of a new client, you find that a \$2,000,000 contingent liability exists that is material to the consolidated company. It is probable that this contingent liability will be resolved with a material loss in the future. Although no adjusting entry has been made, the client has provided a note to the financial statements that describes the matter in detail and includes the \$2 million estimate.		
5. A client is issuing two years of comparative financial statements. The first year was audited by other auditors who are not being asked to reissue their audit report.		
6. An entity changes its depreciation method for production equipment from the straight-line to the units-of-production method based on hours of utilization. You concur with the change.		
7. A client has changed the method it uses to calculate postemployment benefits from one acceptable method to another acceptable method. The effect of the change is immaterial this year but is expected to be material in the future.		
8. Auditors that you will appropriately treat as component auditors have audited a subsidiary of your client as a part of a group audit.		
9. A client omits note disclosure related to significant accounting policies that the auditors believe to be fundamental to users' understanding of the financial statements.		
10. A client does not count its year-end inventory. The auditors are unable to obtain sufficient appropriate audit evidence related to the inventory, and they consider inventory to represent an extremely substantial proportion of the financial statements.		

Research and Discussion Case

LO 17-3, 4



- 17–42. Your firm audits Metropolitan Power Supply (MPS). The issue under consideration is the treatment in the company's financial statements of \$700 million in capitalized construction costs relating to Eagle Mountain, a partially completed nuclear power plant.

Seven years ago, MPS began construction of Eagle Mountain, with an original cost estimate of \$400 million and completion expected within five years. Cost overruns were enormous, and construction has been repeatedly delayed by litigation initiated by the antinuclear lobby. At present, the project is little more than 50 percent complete, and construction has been halted because MPS does not have the funds to continue.

If Eagle Mountain is ultimately completed, the state utilities commission will determine the extent to which MPS may recover its construction costs through its rate structure. The commission's rulings are difficult to predict, but it is quite possible that the commission will not allow MPS to include all of the Eagle Mountain construction costs in its "rate base." If Eagle Mountain were abandoned today, none of the construction costs would be recoverable. The related write-off would amount to over 70 percent of MPS's stockholders' equity, but the company would survive.

MPS's management, however, remains committed to the completion of the Eagle Mountain facility. Management has obtained authorization from the company's stockholders to issue \$500 million in bonds and additional shares of common stock to finance completion of the project. If MPS incurs this additional debt and is still not able to make Eagle Mountain fully operational, it is doubtful that the company can avoid bankruptcy. In short, management has elected to gamble—all its chips are riding on Eagle Mountain.

- Discuss the arguments for and against the auditors insisting that MPS begin expensing some portion of the construction costs rather than continuing to accumulate an ever-increasing asset. Indicate the position you would take as the auditor.
- Discuss whether the auditors should modify their report because of uncertainty about whether or not MPS can remain a going concern. Indicate the type of opinion that you would issue. (You need not limit yourself to a "going concern" modification.)

Part a:

FASB *Accounting Standards Codification* sections 360-10 and 450-20-25-2.

Part b:

AICPA AU-C sections 570 and 700–706; PCAOB AS sections 2415 and 3101.

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Integrated Audits of Public Companies

LO 18-1

Describe the nature of an integrated audit.

In this chapter, we provide information on **integrated audits** based on the provisions of Public Company Accounting Oversight Board (PCAOB) AS 2201, “An Audit of Internal Control over Financial Reporting That Is Integrated with an Audit of Financial Statements,” originally issued as PCAOB *Standard No. 5* prior to the PCAOB’s recodification of its standards. Throughout this chapter, our emphasis is on presenting (1) details on audits of internal control over financial reporting and (2) information on how financial statement audits are modified when the auditors perform an integrated audit. Although we have referred to integrated audits earlier in the text, in this chapter we emphasize in detail the nature of a public company audit. While an integrated audit involves an enhanced consideration of internal control, the financial statement audit’s various planning, evidence-gathering, and reporting procedures remain largely unchanged. Accordingly, the focus of this chapter is on audits of internal control over financial reporting.

Overview

The Sarbanes-Oxley Act of 2002 requires that, in addition to reporting upon financial statements, auditors of public companies also should report upon internal control over financial reporting (hereafter, internal control). Consistently, PCAOB AS 2201 recognizes this relationship and states that the internal control and financial statement audits should be viewed as integrated.

Section 404 is composed of two distinct sections.¹ Section 404(a), which applies to all public companies, requires that each annual report filed with the Securities and Exchange Commission include an internal control report prepared by management in which management acknowledges its responsibility for establishing and maintaining adequate internal control and provides an assessment of internal control effectiveness as of the end of the most recent fiscal year. Section 404(b), which applies to most public companies,² requires the CPA firm to audit internal control and express an opinion on the effectiveness of internal control. While the emphasis of this chapter is on the auditors’ responsibility under Section 404(b), we will begin with an overview of management’s responsibility.

¹ While we emphasize Section 404 in this chapter, we also incorporate information from Section 103, which requires auditor reporting on internal control. In addition, other sections of the Sarbanes-Oxley Act are also relevant to the overall area of audits of financial statements. Section 302 requires each of a company’s principal executives and financial officers to certify the financial and other information contained in the company’s quarterly and annual reports. These certifications must indicate that, based on the officer’s knowledge, the financial statements and other financial information included in the report fairly present, in all material respects, the financial condition and results of operations of the company as of, and for, the period presented in the report. Section 906 includes a similar certification requirement but amends the Federal Criminal Code and explicitly sets forth possible criminal penalties for certifications that do not comply with the requirements.

² In general, companies with less than \$75 million in market capitalization or less than \$100 million in revenues the preceding year are not required to have a separate audit of internal control. More complete details are available in SEC Release No. 34-88365; File No. S7-06-19, available at: <https://www.sec.gov/rules/final/2020/34-88365.pdf>.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 18-1** Describe the nature of an integrated audit.
- LO 18-2** Discuss management’s responsibility for reporting on internal control as required by the Sarbanes-Oxley Act of 2002.
- LO 18-3** Describe the auditors’ responsibility for reporting on internal control through integrated audits as required by the Public Company Accounting Oversight Board.
- LO 18-4** Present the auditors’ approach to analyzing internal control when performing an integrated audit.
- LO 18-5** Explain how findings relating to the audits of internal control and the financial statements may affect one another.
- LO 18-6** Describe the standard audit report on internal control and discuss circumstances that require its modification.

Management's Responsibility for Internal Control

LO 18-2

Discuss management's responsibility for reporting on internal control as required by the Sarbanes-Oxley Act of 2002.

Management has always been responsible for maintaining effective internal control. However, the **Sarbanes-Oxley Act of 2002** increases management's responsibility for demonstrating that controls are effective. As operationalized by the Securities and Exchange Commission (SEC), management is required to

- Accept responsibility for the effectiveness of internal control.
- Evaluate the effectiveness of internal control using suitable control criteria.
- Support the evaluation with sufficient evidence.
- Provide a report on internal control.

Management's report and the auditors' opinion must be included in Form 10-K, the annual report filed with the SEC. The Sarbanes-Oxley Act requires management to perform the above steps in a meaningful manner to support its report. While the exact wording of the report is left to management's discretion, Section 404(a) of the Sarbanes-Oxley Act requires the report to

- State that it is management's responsibility to establish and maintain adequate internal control.
- Identify management's framework for evaluating internal control.
- Include management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the most recent fiscal period, including a statement as to whether internal control over financial reporting is effective.
- Include a statement that the company's auditors have issued an audit report on management's assessment.

Management's Evaluation Process and Assessment

For most SEC registrants, passage of Sarbanes-Oxley resulted in a one-time major project of evaluating and improving internal control to allow both management and the auditors to conclude that the company's internal control is effective. Then, for each subsequent year's reporting, the analysis is updated. The overall process is one of identifying the significant controls and testing their design and operating effectiveness.

The project is performed either by the company itself or by the company assisted by consultants—often personnel from a CPA firm that does not audit the company's financial statements. The company's external auditing firm may provide only limited assistance to management to avoid a situation in which its assessment is in essence part of management's assessment, as well as its own. That is, the CPA firm performing the audit should not create a situation in which management relies in any way on the CPA firm's assessment in making its own assessment.

As a starting point, the Securities and Exchange Commission, which provides operational guidance for implementing the Sarbanes-Oxley requirements, has adopted the following definition for internal control:

Internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and affected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

1. Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;
2. Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and
3. Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Management's report must be based on the preceding definition of internal control and must result from an evaluation using an accepted "control framework." Although not required, the control framework ordinarily used is the *Internal Control–Integrated Framework*, created by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The COSO framework (revised 2013), discussed in detail in Chapter 7, is also the internal control framework commonly used in audits of financial statements.

To perform its evaluation and make its assessment,³ management must understand the concepts of control deficiency, significant deficiency, and material weakness—concepts originally presented in Chapter 7 of this text, although the latter two terms are defined differently for purposes of an integrated audit. A **control deficiency** exists when the design or operation of a control does not allow management or employees, in the normal course of performing their functions, to prevent or detect misstatements on a timely basis.

A **material weakness** is a control deficiency, or combination of control deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis. A reasonable possibility exists when the likelihood is either "reasonably possible" or "probable," as those terms are used in FASB ASC 450-20, "Loss Contingencies."

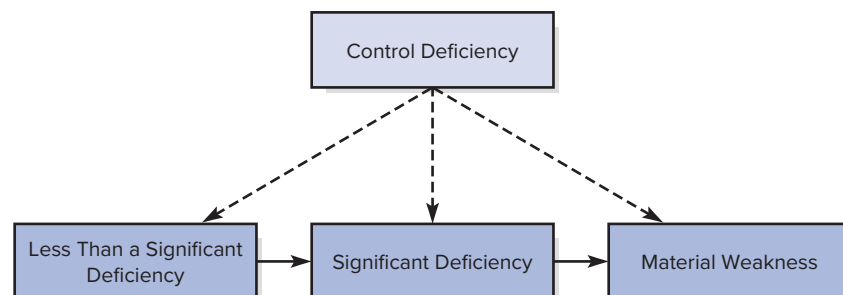
A **significant deficiency** is a control deficiency, or a combination of control deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

Figures 18.1 and 18.2 illustrate relationships among deficiencies, significant deficiencies, and material weaknesses.

FIGURE 18.1
Comparison of Control
Deficiency, Significant
Deficiency, and Material
Weakness Definitions

Deficiency	Severity	Does Existence Result in Required Modification of Management's Assessment and Auditors' Report?
Control Deficiency	Not directly considered in definition	Only if it is a material weakness
Significant Deficiency	Less severe than a material weakness	No
Material Weakness	Reasonable possibility of a material misstatement	Yes

FIGURE 18.2
Levels of Severity of
Control Deficiencies



³ The "evaluation" or "evaluation process" refers to the methods and procedures management implements to comply with the requirements. The "assessment" is the disclosure required in management's report on internal control discussing any material weaknesses and management's assessment of the effectiveness of internal control.

In evaluating the significance of identified deficiencies, both quantitative and qualitative factors are considered. Quantitative factors address the potential amount of loss. Qualitative factors include consideration of the nature of the accounts and assertions involved and the possible future consequences of the deficiency. Chapters 6 and 16 of this text include discussions of qualitative factors affecting materiality judgments.

Additionally, the consideration of a control deficiency also should include analysis of whether a **compensating control** exists to either prevent or detect the possible misstatement. For example, assume a company has a deficiency in control over cash disbursements. The compensating control of reconciliation of cash accounts by a competent individual who is otherwise independent of the cash function might make the likelihood of not detecting a significant misstatement less than reasonably possible. Therefore, while a deficiency might exist, it might not be a significant deficiency or a material weakness due to the existence of a compensating control.

Management must identify the significant financial statement accounts in order to evaluate the controls over major classes of transactions. **Major classes of transactions** are those that materially affect significant financial statement accounts—either directly through entries in the general ledger or indirectly through the creation of rights or obligations that may or may not be recorded in the general ledger.

The overall objective of management's evaluation of internal control is to provide it with a reasonable basis for its annual assessment as to whether there are any material weaknesses in internal control as of the end of the fiscal year. How does management go about achieving this objective? The SEC guidance is structured about two broad principles: (1) evaluating the design of controls to identify controls and risks and (2) evaluating the operation of the controls. This is consistent with the internal control coverage throughout the text—first consider the design and then the operating effectiveness of controls.

Evaluating Design Effectiveness of Controls

The evaluation process begins with identifying and assessing the risks to reliable financial reporting. Management then considers whether it has controls placed in operation (implemented) that are designed to adequately address those risks. Management ordinarily uses a top-down approach in which it begins with the identification of entity-level controls and works down to detailed controls only to the extent necessary. For example, if management determines that a control within the company's period-end financial reporting process (an entity-level control) is designed to adequately address the risk of a material misstatement of interest expense, management may not need to identify any additional controls related to interest expense. When additional assurance is needed, consideration of additional controls becomes necessary. Because the process auditors go through is similar, we discuss this in greater detail later in the chapter.

Evaluating Operating Effectiveness of Internal Control

Management then evaluates operating effectiveness of controls in those areas that pose a high risk to reliable financial reporting. Evidence on operating effectiveness is obtained from tests of controls and from ongoing monitoring activities related to the controls. Tests of controls are similar to those performed by financial statement auditors as described in detail in Chapter 7. Management also considers the effects of ongoing monitoring. Ongoing monitoring includes activities that provide information about the operation of controls. This information is obtained, for example, through assessments made by employees, assessments made by management (referred to as *self-assessment* procedures), and the analysis of performance measures designed to track the operation of controls (e.g., budgets).

Documentation

A required part of management's evaluation process is appropriate documentation of internal control. The documentation often occurs throughout the entire evaluation

FIGURE 18.3
Management Report on
Internal Control

Management is responsible for establishing and maintaining adequate internal control over financial reporting. Carver Company's internal control system was designed to provide reasonable assurance to the company's management and board of directors regarding the preparation and fair presentation of published financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even a system determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. *[Note: This paragraph is not required.]*

We assessed the effectiveness of the company's internal control over financial reporting as of December 31, 20X4. In making this assessment, we used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control—Integrated Framework*. Based on our assessment, we believe that, as of December 31, 20X4, the company's internal control over financial reporting is effective based on those criteria.

Carver Company's independent auditors have issued an audit report on our assessment of the company's internal control over financial reporting. This report appears on page XX.

Sally Jones

Chief Executive Officer
 February 12, 20X5

John Hankson

Chief Financial Officer

process. Virtually all of the documentation tools included in Chapters 7 and 8 of this text are relevant for both management's evaluation and the external auditors' audit of internal control.

Reporting

Management's evaluation process culminates with the issuance of management's report on internal control, which includes management's assessment. If management believes that no material weaknesses exist at year-end, it is able to issue a report concluding that the company maintained effective internal control over financial reporting. An illustration of such a report is included in Figure 18.3. In the next section, we will describe the auditors' process for evaluating and reporting on internal control.

The Auditors' Responsibility for Reporting on Internal Control in PCAOB Audits

LO 18-3

Describe the auditors' responsibility for reporting on internal control through integrated audits as required by the Public Company Accounting Oversight Board.

Public companies with a market capitalization in excess of \$75 million are required to have an integrated audit that includes an audit of internal control over financial reporting. The auditors' objective in an audit of internal control is to express an opinion on the company's internal control. To meet this objective, the auditors must plan and perform the audit to obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment. Evidence is gathered on both the design and operating effectiveness of internal control as of the date specified in management's assessment—normally the last day of the company's fiscal year. The audit may be viewed as consisting of the following five stages:

1. Plan the engagement.
2. Use a top-down approach to identify controls to test.
3. Test and evaluate design effectiveness of internal control.
4. Test and evaluate operating effectiveness of internal control.
5. Form an opinion on the effectiveness of internal control.

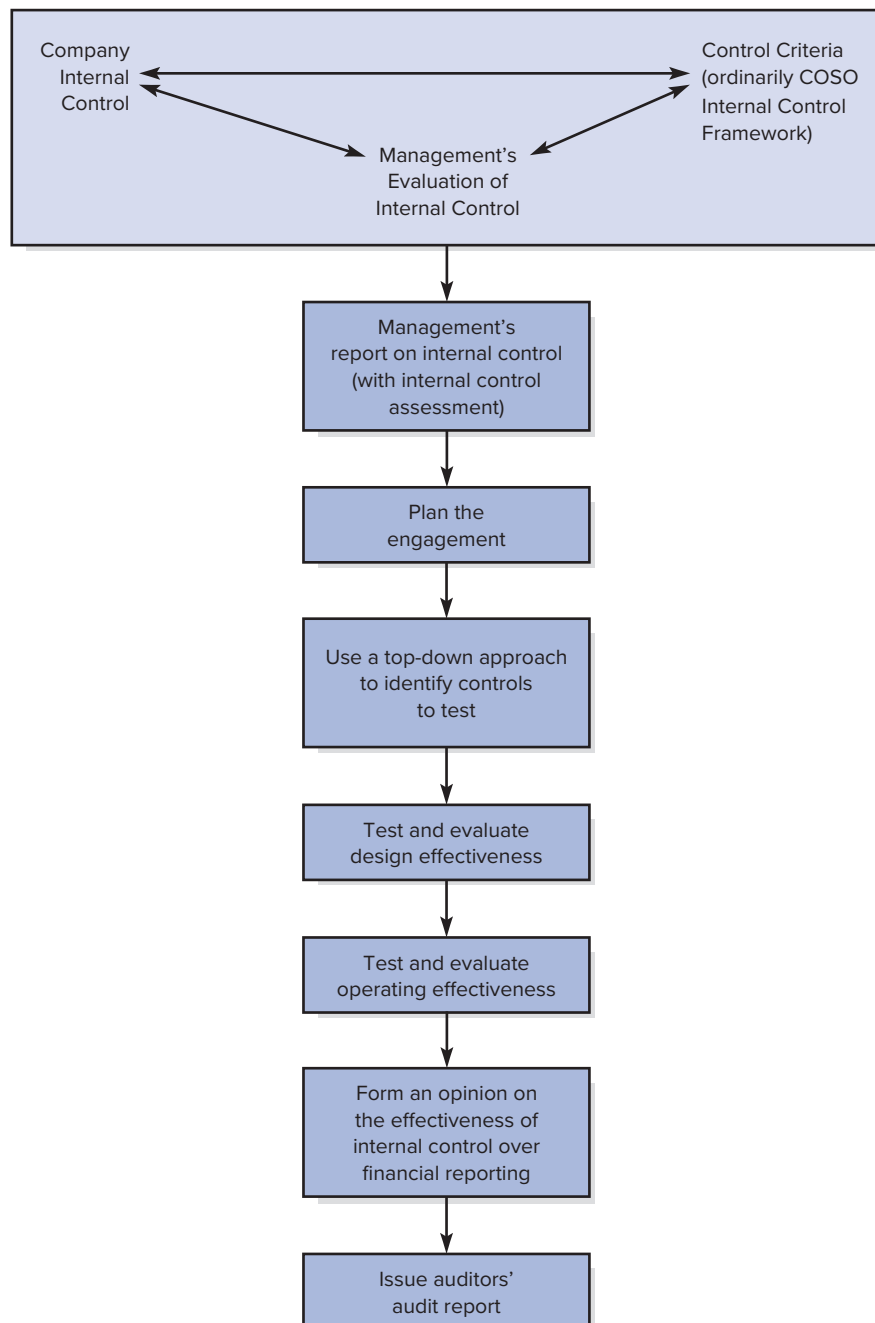
Plan the Engagement

LO 18-4

Present the auditors' approach to analyzing internal control when performing an integrated audit.

As indicated in Figure 18.4, the auditors first plan the engagement. Efficient planning requires coordination with the financial statement audit. For purposes of both audits, the auditors consider matters related to the client's industry, regulatory matters, the client's business, and any recent changes in the client's operations. The auditors' knowledge of a client's internal control at the planning stage of the engagement will differ significantly depending upon the nature of the client and the auditors' experience with that client, and this in turn will affect the scope of the auditors' procedures. For example, when the auditors have previously performed audits of the client, they begin the integrated audit with more information than in a circumstance in which the company is a new audit client. Accordingly, they only have to perform procedures to update their knowledge.

FIGURE 18.4
An Audit of Internal Control over Financial Reporting



There is a subtle difference between the auditors' consideration of internal control for the audit of internal control as compared to their consideration of internal control in an audit of financial statements. In the audit of internal control, the focus is on whether internal control is effective at a point in time—the **as of date**—which is ordinarily the last day of the client's fiscal period. To express the internal control opinion, the auditors must obtain sufficient evidence on the effectiveness of controls at that date. By itself, this would involve performing tests of controls for a period that is usually significantly less than the entire year. On the other hand, in a financial statement audit, the consideration of internal control is performed to help plan the audit and to assess control risk for the entire financial statement period. Therefore, the auditors must perform tests of controls of transactions occurring throughout the year to meet the objective of obtaining sufficient evidence to support the opinion on internal control and assess control risk. This distinction is discussed in more detail later in this chapter.

When planning and performing the audit of internal control, the auditors should take into account the results of the financial statement fraud risk assessment. Specifically, the auditors should identify and test controls that address the risk of fraud, including the possibility of management override of other controls. These controls include those over

- Significant unusual transactions, particularly those reported late in the period and those related to the period-end financial reporting process.
- Related party transactions.
- Significant management estimates.
- Incentives for management to falsify or inappropriately manage financial results.

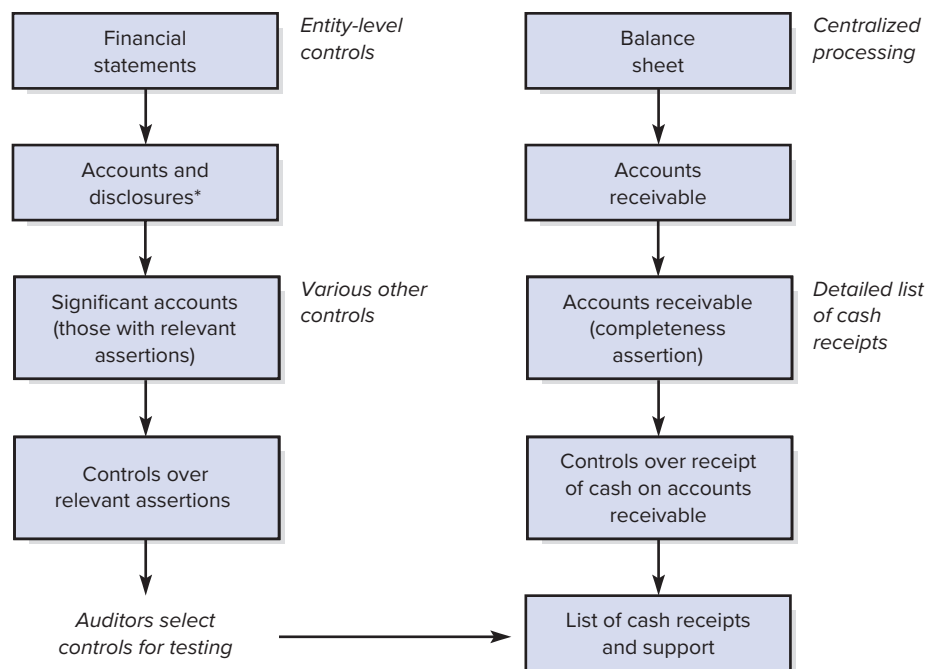
When planning and performing the audit of internal control, the auditors should also recognize internal control differences between small and large clients. Often these differences are related to the degree of complexity of their operations. For example, when the auditors are auditing a small company, many control objectives may be accomplished through daily interaction of senior management and other company personnel rather than through formal policies and procedures. Because of the extensive involvement of senior management in performing controls and the period-end financial reporting process, the auditors of a small company should realize that controls to prevent management override are even more important than they are for a large company. Accordingly, for example, while detailed oversight by the audit committee may be an important control for most companies, it may be particularly important for a small company.

Use a Top-Down Approach to Identify Controls to Test⁴

Figure 18.4 indicates that the auditors use a top-down approach to identify controls to test. What is meant by applying a “top-down” approach? In applying a top-down approach to the audit of internal control over financial reporting, the auditors begin with the financial statements and use their knowledge of internal control and other client information to consider risks at that level and work down to significant accounts and disclosures, which are those with **relevant assertions**. The auditors then select for testing those controls that sufficiently address the assessed risks of material misstatement relating to each relevant assertion. Figure 18.5 outlines this process, which has a goal of testing controls that are most important to the auditor's conclusion on internal control, while limiting testing of those that are less important.

⁴ This terminology is used in PCAOB AS 2201. This stage corresponds to obtaining an understanding of internal control in a financial statement audit.

FIGURE 18.5
A Top-Down Approach
to Testing Internal
Control



Entity-Level Controls

Entity-level controls often are those included in the control environment or monitoring components of internal control. For example, the portions of the control environment dealing with integrity and ethical values, oversight by the board of directors, and appropriate assignment of authority and responsibility have a pervasive effect on internal control. Also, information technology general controls over program development, program changes, and computer controls over processing have a pervasive effect in that they help ensure that specific controls over processing are operating effectively. The pervasiveness of entity-level controls distinguishes them from other controls that are designed to achieve the specific objectives. An example of a control with a specific control objective is the requirement of accounting for all shipping documents. This control activity is aimed primarily at assuring the completeness of recorded sales and does not have the pervasive effect of an entity-level control.

Entity-level controls relating to audit committee effectiveness, fraud, and the period-end financial reporting process are particularly emphasized in PCAOB AS 2201. The audit committee is particularly important because an effective audit committee exercises oversight responsibility over both financial reporting and internal control. Indeed, ineffective audit committee oversight by itself is regarded as a strong indication that a material weakness in internal control exists.

PCAOB AS 2201 also emphasizes the need for controls specifically intended to address the risk of fraud. These controls range from entity-level control environment controls, such as an appropriate tone at the top, corporate codes of conduct, and an effective antifraud program, to control activities, such as the reconciliation of cash accounts. Figure 18.6 provides examples of antifraud programs and elements.

The period-end financial reporting process (often referred to as “financial statement close”) is also very significant. The period-end process involves the procedures used to enter transaction totals into the general ledger through the end of the financial statement reporting process. Auditors should thoroughly evaluate this process, including the manner in which financial statements are produced, the extent of information technology involved, who participates from management, the locations involved, and the types of adjusting entries and oversight by appropriate parties.

FIGURE 18.6
Entity-Level Antifraud
Programs and Elements



Antifraud Program or Element	Strong Indicator of Significant Deficiency
Management accountability	Senior management conducts ineffective oversight of antifraud programs and controls.
Audit committee	Audit committee passively conducts oversight. It does not actively engage the topic of fraud.
Internal audit	Inadequate scope of activities. Inadequate communication, involvement, and interaction with the audit committee.
Code of conduct/ethics	Nonexistent code or code that fails to address conflicts of interest, related party transactions, illegal acts, and monitoring by management and the board. Ineffective communication to all covered persons.
"Whistleblower" program*	No program for anonymous submissions. Inadequate process for responding to allegations of suspicions of fraud. Whistleblower program significantly defective in design or operation.
Hiring and promotion procedures	Failure to perform substantive background investigations for individuals being considered for employment or promotion to a position of trust.
Remediation	Failure to take appropriate and consistent remedial actions with regard to identified significant deficiencies, material weaknesses, actual fraud, or suspected fraud.

* A program for handling complaints and for accepting confidential submissions of concerns about questionable accounting, auditing, and other matters (e.g., hotlines).

In considering entity-level controls, as discussed in Chapter 7, the auditors should be aware that controls may have either an indirect or a direct effect on the likelihood of misstatement. Controls with an indirect effect on the likelihood of misstatement might affect the auditors' decisions about the other controls that the auditors select for testing, as well as the nature, timing, and extent of procedures the auditors perform on other controls. For example, a positive tone at the top of the organization may indirectly lead to more effective lower-level control performance, yet it does not have a direct effect on the likelihood of misstatement for any particular assertion. Yet, such a control might allow the auditors to decrease the testing of other lower-level direct controls.

Controls with a direct effect on the likelihood of misstatement operate at varying levels of precision. Some of these controls might be designed to identify possible breakdowns in lower-level controls and operate at a level of precision that would allow auditors to reduce, but not eliminate, the testing of other controls. As an example, a monitoring control that detects only relatively large misstatements may fall into this category. When such a control is operating effectively, it might allow the auditor to reduce, but not eliminate, the testing of other controls.

Other entity-level controls that have a direct effect on the likelihood of misstatement might be designed to operate at a level of precision that would adequately prevent or detect material misstatements to one or more relevant assertions. Such controls may allow the auditor to omit testing additional controls relating to that risk. Monitoring controls that identify relatively small misstatements may fall into this category. Note, however, that this area has been controversial as some have asked how frequently such controls actually exist, and thus allow the elimination of testing of controls beneath "the top."

Accounts and Disclosures

As shown in Figure 18.5, the auditors should obtain an understanding of the financial statement accounts and disclosures. The purpose at this stage is to identify the **significant accounts and disclosures**, those with one or more relevant assertions. Stated in other terms, a significant account or disclosure has a reasonable possibility of containing a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both understatement and overstatement. The assessment should be made without giving any consideration to the effectiveness of internal control. Factors that the PCAOB presents (AU 2201) for auditors to consider in deciding whether an account is significant include

- Size and composition.
- Susceptibility of loss due to errors or fraud.
- Volume of activity, complexity, and homogeneity of individual transactions.
- Nature of the account.
- Accounting and reporting complexity.
- Exposure to losses.
- Possibility of significant contingent liabilities.
- Existence of related party transactions.
- Changes from the prior period.

Addressing Relevant Financial Statement Assertions

When the auditors have identified the significant accounts and disclosures, they will address the relevant assertions. Recall that throughout the text we have added “cutoff” (transactions being recorded in the proper period) to the FASB set of five assertions: (1) existence or occurrence, (2) completeness, (3) valuation or allocation, (4) rights and obligations, and/or (5) presentation and disclosure. For any account, not all assertions are likely to be considered relevant assertions. For example, valuation may be very relevant to determining the amount of receivables, but it is not ordinarily relevant to cash unless currency translation is involved.

Using the Understanding of Internal Control

Auditors will use their understanding of internal control and the flow of transactions to identify the likely sources of potential misstatements relating to the various relevant assertions. This understanding allows the auditors to identify points within the company’s processes where a material misstatement could arise and to identify the controls to prevent or detect these misstatements.

Throughout the text (e.g., Chapter 6 and Chapters 10–15), we have discussed the concept of transaction cycles. Transaction cycles (also referred to as classes of transactions) are those transaction flows that have a meaningful bearing on the totals accumulated in the company’s significant accounts and, therefore, have a meaningful bearing on relevant assertions. Consider a company whose sales may be initiated by customers either through the Internet or in a retail store. These two types of sales may be viewed as representing two major classes of transactions within the sales process.

Although not explicitly discussed in PCAOB AS 2201, it is helpful to classify transactions by *transaction type*: routine, nonroutine, or accounting estimates. **Routine transactions** are for recurring activities, such as sales, purchases, cash receipts and disbursements, and payroll. **Nonroutine transactions** occur only periodically; they generally are not part of the routine flow of transactions and include transactions such as counting and pricing inventory, calculating depreciation expense, or determining prepaid expenses. **Accounting estimates** are activities involving management’s judgments or assumptions, such as determining the allowance for doubtful accounts, estimating warranty reserves, and assessing assets for impairment.

Throughout the audit of internal control, auditors must be concerned about all three transaction types. However, the auditors must be aware that the unique nature of nonroutine transactions and the subjectivity involved with accounting estimate transactions make them particularly prone to misstatement unless they are properly controlled.

To understand the likely sources of potential misstatements and as a part of selecting the controls to test, the auditors should

- Understand the flow of transactions.
- Verify points within the company's processes at which a misstatement could arise that could be material.
- Identify the controls management has implemented to address these potential misstatements.
- Identify the controls management has implemented to prevent or detect on a timely basis unauthorized acquisition, use, or disposition of the company's assets that could result in a material misstatement.

Figure 18.7 provides an illustration of the relationships among significant accounts, processes, and transaction types emphasizing inventory processes; it presumes one major class of transactions for each process.

FIGURE 18.7 Relationships among Processes, Transaction Types, and Significant Accounts

Example Processes	Transaction Types	Examples of Significant Accounts								
		Cash	Accounts Receivable	Allowance for Doubtful Accounts	Inventories	Inventory Reserves	Prepaid	Property, Plant, and Equipment	Other Accounts	Stockholders' Equity
Financial statement close	Nonroutine	X	X	X	X	X	X	X	X	X
Cash receipts	Routine	X	X						X	
Cash disbursements	Routine	X							X	
Payroll	Routine									
Inventory costing (CGS)	Routine	X			X					
Estimate purchase commitments	Estimation								X	
Estimate excess and obsolete inventory	Estimation					X				
Lower-of-cost-or-market calculation	Estimation					X				
LIFO calculation	Nonroutine					X				
Physical inventory count	Nonroutine					X				
Accounts receivable and sales	Routine		X							

Source: Adapted from Ernst & Young, "Evaluating Internal Control: Considerations for Documenting Controls at the Process, Transaction, or Application Level" (2003).

Selecting Controls to Test

The auditors should test those controls that are important to their conclusion about whether the company's controls sufficiently address the risk of misstatement for each relevant assertion. It is not necessary to design tests of all controls. For example, tests of **redundant controls** (those that duplicate other controls) need not be designed when tests of the related control are planned, unless redundancy itself is needed to meet the control objectives. The auditors may decide to design tests of preventive controls, detective controls, or a combination of both for the various assertions and significant accounts. Preventive controls have the objective of preventing errors or fraud from occurring; detective controls have the objective of detecting errors or fraud that has already occurred. Effective internal control generally involves "levels" of controls composed of a combination of both preventive and detective controls. Some controls are **complementary controls** in that they work together to achieve a particular control objective. When tests are performed related to that control objective, the complementary controls should be tested.

A question that arises when a client has multiple locations is: Are auditors required to always design and perform tests at all locations? The answer is no. In determining the locations at which to perform tests of controls, the auditor should assess the risk of material misstatement to the financial statements of each location and base the amount of testing at various locations on the degree of risk.

Performing Walk-throughs

While not required, performing walk-throughs may frequently be the most effective way to obtain an understanding of the likely sources of misstatement. A **walk-through** involves literally tracing a transaction from its origination through the company's information system until it is reflected in the company's financial reports. Walk-throughs provide the auditors with evidence to

- Verify that they have identified points at which a significant risk of misstatement to a relevant assertion exists.
- Verify their understanding of the design of controls, including those related to the prevention or detection of fraud.
- Evaluate the effectiveness of the design of controls.
- Confirm whether controls have been placed in operation (implemented).

Because much judgment is required in performing a walk-through, the auditors should either perform walk-throughs themselves or supervise the work of others who provide assistance to them (e.g., internal auditors).

While performing walk-throughs, the auditors ask those involved to describe their understanding of the processing involved and to demonstrate what they do. In addition, follow-up inquiries should be made to help identify abuse of controls or indicators of fraud. Examples of such follow-up inquiries include

- What do you do when you find an error?
- What kind of errors have you found?
- What happened as a result of finding the errors, and how were the errors resolved?
- Have you ever been asked to override the process or controls? If yes, why did it occur and what happened?

Test and Evaluate Design Effectiveness of Internal Control over Financial Reporting

The auditors test the design effectiveness of controls by determining whether the company's controls, if operating properly, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements. The procedures performed here include a combination of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Figure 18.8 provides an example of control objectives, risks, and controls using the COSO framework. The auditors specifically consider whether the controls, if functioning, would reduce the risks to an appropriately low level.

FIGURE 18.8 Process: Accounts Receivable

Control Objective	Risks	Controls
1. Ensure that all goods shipped are accurately billed in the proper period.	Missing documents or incorrect information Improper cutoff of shipment at the end of a period	• Use standard shipping or contract terms. • Communicate nonstandard shipping or contract terms to accounts receivable department. • Identify shipments as being before or after period-end by means of a shipping log and prenumbered shipping documents.
2. Accurately record invoices for all authorized shipments and only for such shipments.	Missing documents or incorrect information	• Prenumber and account for shipping documents and sales invoices. • Match orders, shipping documents, invoices, and customer information, and follow up on missing or inconsistent information. • Mail customer statements periodically and investigate and resolve disputes or inquiries by individuals independent of the invoicing function. • Monitor number of customer complaints regarding improper invoices or statements.
3. Accurately record all authorized sales returns and allowances and only such returns and allowances.	Missing documents or incorrect information	• Authorization of credit memos by individuals independent of accounts receivable function. • Prenumber and account for credit memos and receiving documents. • Match credit memos and receiving documents and resolve unmatched items by individuals independent of the accounts receivable function.
	Inaccurate input of data	• Mail customer statements periodically and investigate and resolve disputes or inquiries by individuals independent of the invoicing function.
4. Ensure continued completeness and accuracy of accounts receivable.	Unauthorized input for nonexistent returns, allowances, and write-offs	• Review correspondence authorizing returns and allowances. • Reconcile accounts receivable subsidiary ledger with sales and cash receipts transactions. • Resolve differences between the accounts receivable subsidiary ledger and the accounts receivable control account.
5. Safeguard accounts receivable records.	Unauthorized access to accounts receivable records and stored data	• Restrict access to accounts receivable files and data used in processing receivables.

Source: Adapted from *Internal Control—Integrated Framework, Evaluation Tools*.

Test and Evaluate Operating Effectiveness of Internal Control over Financial Reporting

Tests of the operating effectiveness of a control determine whether the control functions as designed and whether the person performing the control possesses the necessary authority and qualifications. In deciding how to design tests of operating effectiveness, the auditors must focus on the nature, timing, and extent of the tests.

Nature of Tests of Operating Effectiveness

Tests of controls include a combination of inquiries of appropriate personnel, inspection of relevant documents, observation of the company's operations, and reperformance of the application of controls. For example, to evaluate whether the second control objective in Figure 18.8, the accurate and complete recording of invoices, is achieved, the auditors might use generalized audit software to inspect electronic documents to determine that no gaps exist in the sequence of shipping documents. Also, PCAOB AS 2201 states that the auditors should vary the exact tests performed when possible to introduce unpredictability into the audit process.



Illustrative Case

Design and Operating Effectiveness of Management Review Controls

The PCAOB (Staff Audit Practice Alert, No. 11) uses **management review**

controls to illustrate appropriate audit testing of *design effectiveness* and *operating effectiveness* of controls.

DESIGN EFFECTIVENESS

The PCAOB suggests that in addressing design effectiveness of management review controls, auditors evaluate

- Whether the control satisfies the corresponding control objectives, including whether it addresses the risks of material misstatement to the relevant assertions of the significant accounts or disclosures.
- The factors affecting the precision of the review, including the objective of the review and the appropriateness of the expectations, level of aggregation, and criteria for investigation for identifying potentially material misstatements. That is, a primary issue here is whether the review performed (e.g., examining changes of a certain amount or percentage) will detect a material misstatement.
- The steps involved in identifying, investigating, and resolving significant differences from expectations.
- The reliability of the information used in the review.
- The competence and authority of the person(s) who performs the control.

- The frequency of performance of the control. Does the review occur often enough to prevent or detect misstatements before they have a material effect on the financial statements?

OPERATING EFFECTIVENESS

Testing the operating effectiveness of a management review control involves performing procedures to evaluate whether the control is working as designed (above) to prevent or detect potentially material misstatements. Testing typically involves obtaining and evaluating evidence about

- The steps performed to identify and investigate significant differences.
- The conclusions reached in the company reviewer's investigation, including whether potential misstatements were appropriately investigated and whether corrective actions were taken as needed.

The nature, timing, and extent of testing should be commensurate with the risk associated with the controls. Higher-risk controls warrant more testing. The auditor also should take into account other relevant evidence obtained in the audit when evaluating the effectiveness of a control, such as identified misstatements that were not prevented or detected by the control. The PCAOB stresses that verifying that a review was signed off, by itself, provides little or no evidence about the control's effectiveness.

Evaluating responses to inquiries represents a particular challenge in that the responses may range from formal written inquiries (e.g., representation letters) to informal oral inquiries. Because of the possibility of misrepresentation or misunderstanding of the responses, inquiry alone does not provide sufficient evidence to support the operating effectiveness of a control. Thus, auditors should substantiate the responses to inquiries by performing other procedures, such as inspecting reports or other documentation relating to the inquiries.

Timing of Tests of Controls

Tests of controls should be performed over a period of time sufficient to determine whether, as of the date specified in management's report, the controls were operating effectively. The auditors are aware that some controls operate continuously (e.g., controls over routine transactions, such as sales), while others operate only periodically (e.g., controls over nonroutine transactions or events, such as the preparation and analysis of monthly or quarterly financial statements). For controls that operate only periodically, it may be necessary to wait until after the date of management's report to test them; for example, controls over period-end financial reporting normally operate only after the date of management's report. The auditors' tests can be performed only at the time the controls are operating.

Extent of Tests of Controls

PCAOB AS 2201 requires the auditors to obtain sufficient evidence about the effectiveness of controls for all relevant assertions related to all significant accounts. This means that the auditors must design procedures to provide a high level of assurance that the controls related to each relevant assertion are operating effectively. For manual controls, this generally involves more extensive testing than for automated controls. Generally, the



Illustrative Case

Frequency of Testing

One CPA firm provided the following guidance to its auditors as to frequency of testing:

Frequency of Control	Suggested Number of Items to Test
Annual	1
Quarterly	2
Monthly	3–6
Weekly	10–20
Daily	20–40
Multiple times per day	30–60

more frequently controls operate, the more auditors should test them, and controls that are relatively more important should be tested more extensively. Also, the auditors cannot be satisfied with less-than-persuasive evidence because of a belief that management is honest.

When control exceptions are identified, the auditors should critically assess the nature and extent of testing and consider whether additional testing is appropriate. Also, a conclusion that an identified control exception does not represent a control deficiency is only appropriate if evidence beyond what the auditors had originally planned, and beyond inquiry, supports that conclusion. The issue of evaluating exceptions will be described in more detail later in this chapter.

Can auditors use the work of others—internal auditors, company personnel, and third parties—in the audit of internal control? For example, if client personnel have already performed certain procedures that the auditors had planned, may the auditors use that work? The answer is yes because PCAOB AS 2201 allows auditors to use the work of others. It is expected that the work of others used by the auditors will often be related to relatively low-risk areas. In any event, the auditors must understand that when they use the work of others, they remain responsible for their opinion and cannot share responsibility with those others. In all cases in which the work of others is used, the auditors should evaluate the competence and objectivity of those individuals and test the work they have performed.

Another issue relates to the degree to which auditors should retest controls in detail each year. In audits subsequent to the first year, auditors should incorporate knowledge obtained during past audits of internal control. Using this “cumulative audit knowledge” (knowledge obtained from prior audits), the auditors often may be able to reduce the amount of work performed. In making decisions as to the necessary testing, the auditors should consider the various risk factors related to a control as well as

- The nature, timing, and extent of procedures performed in previous audits.
- The results of the previous years’ testing of the control.
- Whether there have been changes in the control, or the significant process in which it operates, since the previous audit.

To illustrate, assume that a control presents a low risk overall in that there are low inherent risk, low degree of complexity, and few changes in controls, and the previous year revealed no deficiencies. In such a case, the auditors may determine that sufficient evidence of operating effectiveness could be obtained by performing a walk-through. In addition, the auditors may use the work of others to a greater extent than in the past. But, on an overall basis, the auditors must test controls every year and cannot “rotate” testing

of various transaction types between various years (e.g., consider controls over sales this year and purchases next year).

LO 18-5

Explain how findings relating to the audits of internal control and the financial statements may affect one another.

Relationship between Tests of Controls Performed for the Internal Control Audit and Those Performed for the Financial Statement Audit

Are the types of tests of controls performed for an internal control audit the same as those performed for a financial statement audit? May the evidence from tests performed for an internal control audit be used for the financial statement audit? While the answer to both of these questions is yes, the auditors should consider the differences in the objectives of the tests.

The objective of tests of controls in an audit of internal control is to obtain evidence about the effectiveness of controls to support the auditors' opinion on whether management's assessment of the effectiveness of internal control, taken as a whole, is fairly stated as of a point in time. Accordingly, to express this opinion, the auditors should obtain evidence about the effectiveness of controls over all relevant assertions for all significant accounts and disclosures in the financial statements.

The objective of tests of controls for a financial statement audit is to assess control risk. If the auditors decide to assess control risk at less than the maximum, they are required to obtain evidence that the relevant controls operated effectively during the entire period upon which they plan to place reliance on those controls. However, the auditors are not required to assess control risk at less than the maximum for all assertions.

How may these two different approaches for tests of controls be reconciled in an integrated audit? PCAOB AS 2201, for purposes of the internal control audit, allows the auditors to obtain evidence about operating effectiveness at different times throughout the year—provided that the auditors update those tests or obtain other evidence that the controls still operated effectively at the end of the year. Thus, although the timing for issuing the internal control report will not ordinarily require tests from throughout the year, the integrated nature of the two audits suggests that testing should be spread throughout the year.

The requirements of PCAOB AS 2201 have had the effect of pushing auditors to perform financial statement audits using the systems approach—an approach with heavy reliance on internal control evidence. In essence, because extensive tests of controls are required for each significant account for the internal control audit, the auditors should have significant evidence about the effectiveness of internal control for the financial statement audit. However, the auditors generally must merely extend the tests to cover the financial statement period in order to assess control risk at a low level for purposes of the financial statement audit.

Effect of Tests of Controls on Financial Statement Audit Substantive Procedures

Historically, to enhance audit efficiency and effectiveness of a financial statement audit, the auditors often have relied significantly on substantive testing, an approach that is not acceptable for integrated audits. Auditors have traditionally relied primarily (or completely) on evidence from substantive procedures rather than testing controls in audit areas when a substantive approach was considered the most cost-effective approach. To illustrate, when only a financial statement audit is being performed, auditors often rely heavily upon substantive procedures to audit areas such as property, plant, and equipment; investments; and long-term debt. Because auditors must now report on the effectiveness of internal control, approaches limiting the testing of controls are not acceptable.

Historically, another efficiency that has developed in financial statement audits is minimizing the testing of controls aimed at **preventive controls** (e.g., transaction level controls) and emphasizing the testing of **detective controls** (e.g., various types of reconciliations and exception reports). When auditors express an opinion on internal control, the auditors are more likely to use an approach that includes testing of both preventive and detective controls.

Because an integrated audit requires tests of controls for all major accounts and relevant assertions, circumstances in which controls are found to be effective will lead to a decreased scope of substantive procedures as compared to a situation in which tests of controls have revealed an ineffective system or a situation in which tests of controls



Illustrative Case

Using Attributes Sampling to Consider Control Deficiencies

It is possible to use statistical attribute sampling (presented in Chapter 9) to consider control deficiency seriousness. Consider a control over authorization of sales transactions:

- 1% = Deviation rate in the auditors' sample
- 6% = Achieved upper deviation rate
- 5% = Risk of assessing control risk too low

If one further assumes that \$3,000,000 of the transaction type occurred, the auditor may estimate that \$180,000

($6\% \times \$3,000,000$) worth of transactions may not have been properly approved. That is, there is at least a reasonable possibility that \$180,000 in transactions was not properly approved.

If one assumes that \$180,000 is material, after considering both quantitative and qualitative factors, the deficiency represents a material weakness. Alternatively, if it is not considered quantitatively material, an auditor must judgmentally determine whether it represents a significant deficiency that should be communicated to the audit committee. Note, however, that the auditors also must take into account qualitative considerations.

have not been performed. However, when significant deficiencies or material weaknesses have been identified, the auditors should obtain assurance that such deficiencies have not resulted in undetected material misstatements. As an example, if controls over the recording of revenues are considered ineffective, the auditors should determine whether the audit procedures designed into their audit program must be modified to obtain more evidence about the fairness of revenue.

The extensive level of controls testing performed during an integrated audit leads to the question of whether substantive tests may be omitted completely in areas in which controls have been found to operate effectively. This is not acceptable. Regardless of the assessed level of control risk, the auditors must perform substantive procedures for all relevant assertions related to all significant accounts and disclosures.

Effect of Financial Statement Substantive Procedures on the Audit of Internal Control

We have shown that the audit of internal control may affect the scope of substantive procedures performed for the financial statement audit. Alternatively, the results of substantive procedures may affect the audit of internal control. The findings obtained while performing substantive procedures in the financial statement audit may provide evidence of the effectiveness or ineffectiveness of internal control over financial reporting. For example, identification of a material misstatement in the financial statements is considered indicative of at least a significant deficiency in internal control. Additional examples of substantive procedures findings that might affect the internal control audit are those relating to illegal acts, related party transactions, the reasonableness of accounting estimates, and the client's overall selection of accounting principles.

Form an Opinion on the Effectiveness of Internal Control over Financial Reporting

LO 18-6

Describe the standard audit report on internal control and discuss circumstances that require its modification.

In forming an opinion on internal control over financial reporting, the auditors evaluate all evidence, including

1. The results of their evaluation of the design.
2. The results of tests of the operating effectiveness of controls.
3. Negative results of substantive procedures performed during the financial statement audit.
4. Any identified control deficiencies.

An unqualified audit opinion may be issued when no material weaknesses in internal control have been identified as existing at the as of date (year-end) and when there have been no restrictions on the scope of the auditors' work. The auditors may issue separate reports on the financial statements and internal control or a combined report. Figure 18.9 is an example of a separate report on internal control.

FIGURE 18.9 Report with Standard Unqualified Opinion on Internal Control over Financial Reporting**Report of Independent Registered Public Accounting Firm**

To the Audit Committee and Stockholders of Carver Company:

Opinion on Internal Control over Financial Reporting

We have audited Carver Company's internal control over financial reporting as of December 31, 20X8, based on criteria established in *Internal Control—Integrated Framework: (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)*.

In our opinion, Carver Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X8, based on criteria established in *Internal Control—Integrated Framework: (2013) issued by COSO*.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the balance sheets of Carver Company as of December 31, 20X8 and 20X7, and the related statements of income, shareholders' equity and comprehensive income, and cash flows for each of the three years for the period ended December 31, 20X8, and the related notes. Our report, dated February 12, 20X9, expressed an unqualified opinion.

Basis for Opinion

Carver Company's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report]. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects.

Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Willington & Co., CPAs

Bisbee, Arizona, United States of America

February 12, 20X9

One or more material weaknesses in internal control result in an adverse opinion.⁵ Scope limitations may result in either a disclaimer or withdrawal from the engagement depending on the extent of the limitation.

Determining whether control deficiencies have been identified and, if so, the likelihood and potential amount of misstatement are key to identifying the proper opinion to issue. If no control deficiencies have been identified and no scope limitations are involved, an unqualified opinion is appropriate.

⁵ Notice that this is different from reports on audits of financial statements. In an audit of financial statements, a departure from generally accepted accounting principles results in either a qualified opinion or an adverse opinion based on materiality.



Illustrative Case

Internal Control Audit Deficiencies

In recent years Audit Analytics, Inc. has issued reviews that included detailed data on the percentage of adverse audit reports issued on company internal control over financial reporting. While in the first years of the reporting requirement (2004–2007) the adverse rate declined from approximately 16 percent to 8 percent, in subsequent years the rate has generally been between 5 to 7 percent. Recently, the most frequently cited

issues relating to the adverse opinions on internal control have included

- Lack of sufficient highly trained accounting personnel.
- Information technology inadequacies.
- Segregation of duties.
- Inadequate disclosure controls.
- Material/numerous year-end adjustments.

Evaluating Deficiencies

The auditors must evaluate whether identified control deficiencies, individually or in combination, are significant deficiencies or material weaknesses. This involves a consideration of both quantitative and qualitative factors.

When a deficiency has been identified, the auditors will consider whether any other controls effectively mitigate the risk of potential misstatement and create a situation in which the deficiency is not significant or, at least, does not constitute a material weakness. Earlier in this chapter, we used the example of a weakness in cash disbursements that was mitigated by the compensating control of reconciliation of the bank account by an individual otherwise independent of the cash function. Such a compensating control might cause the auditors to alter their assessment of a deficiency—reducing it from one that otherwise would be considered significant (or a material weakness) to one that is simply a control deficiency.

In evaluating the potential amount of misstatement related to a control deficiency, the auditors should consider not only the misstatements identified, but also the amount that could occur with a reasonable possibility. Although there are various possible approaches to this evaluation, one is to directly consider whether a reasonable possibility exists that a material amount of misstatement could occur. If that is the case, the deficiency is a material weakness. Alternatively, if the deficiency is less severe than a material weakness, yet important enough to merit the attention by those responsible for oversight of the company's financial reporting (ordinarily the audit committee), the deficiency represents a significant deficiency.

The auditors also must consider qualitative factors when evaluating materiality, as is the case with financial statement audits. Examples of qualitative factors include whether the weakness relates to related party transactions and whether there are changes in account characteristics in relation to the prior year. Chapter 6 presents additional information on qualitative factors that are used by the auditors. In essence, the auditors should attempt to determine what prudent officials in the conduct of their own affairs would consider a significant deficiency or a material weakness.

While a material weakness in internal control can arise in a wide variety of situations, PCAOB AS 2201 provides the following indicators of material weaknesses:

- Identification of fraud, whether or not material, on the part of senior management.
- Restatement of previously issued financial statements to reflect the correction of a material misstatement.
- Identification by the auditors of a material misstatement in circumstances that indicate that the misstatement would not have been detected by the company's internal control.
- Ineffective oversight of the company's external financial reporting and internal control by the company's audit committee.

Correcting a Material Weakness

Recall that the audit report is modified for material weaknesses that exist at the as of date (year-end). Consider a situation in which four months prior to year-end management identifies a material weakness. If management corrects this weakness prior to year-end, can the auditors issue an unqualified opinion on internal control? Yes, but only if the auditors have sufficient evidence to provide reasonable assurance that the new control is operating effectively. Obtaining such evidence is much easier for controls that operate frequently, in contrast to those that operate only monthly or quarterly (e.g., financial statement close). All in all, the timing of the identification of the material weakness is very important. For example, if the material weakness is not identified until after year-end, an adverse opinion must be issued even if the weakness is corrected; the control did not operate effectively on the date of management's report.

Audit Report Modifications

Existence of a Material Weakness

A material weakness in internal control that exists at year-end results in the issuance of an adverse opinion. When expressing an adverse opinion, the auditors' report must define a material weakness, indicate that one has been identified, and refer to the description of it in management's report. Figure 18.10 provides an example of an adverse opinion.⁶

Scope Limitations

If a restriction on the scope of the audit is imposed by the circumstances, the auditors should withdraw from the engagement or disclaim an opinion. Earlier we discussed the situation in which the auditors identify a material weakness and management takes steps to correct that material weakness prior to year-end. If the auditors are unable to obtain sufficient evidence that the new controls are effective for a sufficient period of time, they will issue a disclaimer of opinion on internal control.

Management's Report on Internal Control Is Incomplete or Improperly Presented

When management's report on internal control (including its assessment) is found to be inadequate, the auditors should modify their report to include an explanatory paragraph

FIGURE 18.10 Abstract of Report with Adverse Opinion on Internal Control over Financial Reporting

Opinion on Internal Control over Financial Reporting

We have audited Carver Company's internal control over financial reporting as of December 31, 20X8, based on criteria established in *Internal Control—Integrated Framework: (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)*.

In our opinion, because of the effect of the material weakness described below on the achievement of the objectives of the control criteria, Carver Company has not maintained effective internal control over financial reporting as of December 31, 20X8, based on criteria established in *Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)*.

A material weakness is a control deficiency, or a combination of control deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis. A material weakness was identified and is described in management's assessment of internal control. That material weakness relates to (describe the material weakness, including its actual and potential effect on the financial statements).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the balance sheets of Carver Company as of December 31, 20X8 and 20X7, and the related statements of income, shareholders' equity and comprehensive income, and cash flows for each of the three years for the period ended December 31, 20X8, and the related notes. Our report, dated February 12, 20X9, expressed an unqualified opinion. [The two other sections of the report, "Basis for Opinion" and "Definition and Limitations of Internal Control over Financial Reporting" are identical to the Figure 18.9 standard unqualified report.]

⁶ In recent years, the percentage of reports with adverse opinions on internal control has approximated 5–6 percent.

FIGURE 18.11 Circumstances Affecting Auditors' Opinion on Internal Control

Circumstance	Auditors' Opinion
Material Weakness Exists	Adverse
Material Weakness Existed during Year, System Changed Prior to the As of Date	
Auditors test new system and material weakness eliminated	Unqualified
Auditors do not have sufficient time to test new system	Treat as scope restriction
Scope Restriction*	Disclaimer or Withdraw from Engagement
Management's Report on Internal Control Is Incomplete or Improperly Presented	
Report does not acknowledge a material weakness identified by the auditor	Adverse
Other Issues	Unqualified (but with an explanatory paragraph)

* If the auditors intend to issue a disclaimer of opinion, yet know of a material weakness, the material weakness should be described in the report.

describing the reasons for this determination. If management does not disclose a material weakness properly, the auditors should state that the material weakness is not included in management's assessment and describe it in the audit report. Note that the auditors' report is already adverse due to the existence of a material weakness. In this situation, the auditors also are required to communicate in writing to the audit committee that the material weakness was not disclosed or identified as a material weakness in management's report. Figure 18.11 summarizes reporting for this and the preceding circumstances described in this section.

Reliance on Other Auditors

When other auditors have performed a portion of the audit, the auditors must decide whether they are able to serve as the principal auditors. The considerations and reporting requirements are essentially the same as when other auditors are involved in the financial statement audit. The auditors who are able to serve as the principal auditors of the financial statements ordinarily also serve as principal auditors of internal control. When the principal auditors decide to refer in their report to the work of the other auditors, this reference is included both in describing the scope of the audit and in expressing the opinion.

Subsequent Events

Subsequent events relevant to the internal control audit are changes in internal control subsequent to year-end but before the date of the auditors' report. Prior to issuance of the report on internal control, the auditors have a responsibility to make inquiries of management about whether there have been any such changes. If the auditors obtain knowledge of subsequent events that materially and adversely affect the effectiveness of internal control, they should issue an adverse opinion. If the auditors are unable to determine the effect of the subsequent event, they should disclaim an opinion.

After issuance of the report on internal control, the auditors may become aware of conditions that existed at the report date that might have affected their opinion if they had been aware of them. This situation is treated similarly to financial statement information discovered subsequent to the date of the audit report—PCAOB AS 2905 presents requirements and Chapter 16 summarizes them.

Issuing a Combined Report on the Financial Statements and Internal Control

PCAOB AS 2201 allows auditors to either issue separate reports on their audits of the financial statements and internal control or issue one combined report. The illustrations in this chapter have been based on separate reports. Figure 18.12 provides an illustration of a combined unqualified report on both the financial statements and internal control.

FIGURE 18.12 Combined Report with Standard Unqualified Opinion on Financial Statements and Internal Control over Financial Reporting**Report of Independent Registered Public Accounting Firm**

To the Audit Committee and Stockholders of Carver Company

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying balance sheets of Carver Company (the “Company”) as of December 31, 20X8 and 20X7, and the related statements of income, stockholders’ equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X8 and the related notes (collectively referred to as the “financial statements”). We also have audited the Company’s internal control over financial reporting as of December 31, 20X8, based on [Identify control criteria: for example, “criteria established in *Internal Control—Integrated Framework: (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)”].

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Carver Company as of December 31, 20X8 and 20X7, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X8 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, Carver Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X8, based on [Identify control criteria, for example, “criteria established in *Internal Control—Integrated Framework: (2013)* issued by COSO”].

Basis for Opinion

The Company’s management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying [title of management’s report]. Our responsibility is to express an opinion on the Company’s financial statements and an opinion on the Company’s internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (“PCAOB”) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the financial statements included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

Definition and Limitations of Internal Control over Financial Reporting

A company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company’s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Critical Audit Matters [if applicable]

[Include critical audit matters]

Willington & Co., CPAs

We have served as the Company’s auditor since 20X1.

Bisbee, Arizona, United States of America

February 12, 20X9

Other Communication Requirements

PCAOB AS 2201 requires that auditors communicate in writing to management all control deficiencies, regardless of their severity—this includes material weaknesses, significant deficiencies, and other deficiencies. In addition, a written communication to the audit committee must be issued that includes material weaknesses, significant deficiencies, and an indication that all deficiencies have been communicated to management. The written communications on weaknesses to both management and the audit committee should be made prior to issuance of the audit report on internal control.

In addition, when the auditors conclude that the oversight of the company's external financial reporting and internal control over financial reporting is ineffective, they must communicate that conclusion in writing to the board of directors.

Reporting on Whether a Previously Reported Material Weakness Continues to Exist

After the existence of a material weakness has led to an adverse opinion in an internal control audit report, the company is ordinarily motivated to eliminate the weakness as quickly as is reasonably possible. When management believes that the material weakness has been eliminated, the auditors may be engaged to report on whether the material weakness continues to exist. PCAOB AS 6115, "Reporting on Whether a Previously Reported Material Weakness Continues to Exist," provides the guidance for such engagements.

To engage the auditors to perform this service, management must first gather sufficient evidence to demonstrate that the material weakness has been eliminated, document this evidence, and provide a written assertion stating that the material weakness no longer exists. The auditors then plan and perform an engagement that focuses on controls that are relevant to the particular weakness. If they determine that the controls are now effective, the auditors may issue an unqualified report indicating that the material weakness no longer exists. PCAOB AS 6115 provides other reporting guidance, including

- As is the case with the original engagement, a significant scope limitation on the auditors' procedures in this type of engagement should result in either a disclaimer of opinion or the resignation of the auditors (qualified opinions are not allowed).
- When the auditors' original report includes other material weaknesses that are not being considered in this engagement, the report should be modified to disclose that the other weaknesses are not addressed by the opinion.
- After a change in auditors, the successor auditors may issue such a report, but they first must obtain a sufficient understanding of the entity and the related material weakness.
- If, while performing the engagement, the auditors discover an additional material weakness, the auditors should inform the audit committee about the matter, but they are not required to modify their report.

Integrated Audits for Nonpublic Companies

While nonpublic companies are not required to undergo integrated audits, the option is available. As an example, management may be considering taking the company public in the relatively near future and might choose to undergo such an audit. AICPA Auditing Standards (AU-C 940) provide guidance for performing an audit of internal control over financial reporting that is integrated with the audit of financial statements for engagements where PCAOB standards do not apply (e.g., engagements involving nonpublic companies). AICPA Standards provide guidance for performing an audit of internal control over financial reporting that is integrated with the audit of the financial statements of a *nonpublic* company.

The procedures for a nonpublic integrated audit are very similar to those for a public company that we have emphasized throughout this chapter.

Chapter Summary

This chapter explained the nature of integrated audits of public companies performed in response to the Sarbanes-Oxley Act of 2002 and in accordance with PCAOB AS 2201. To summarize:

1. Section 404(a) of the Sarbanes-Oxley Act requires management to acknowledge its responsibility for establishing and maintaining adequate internal control and provide an assessment of internal control effectiveness as of the end of the most recent fiscal year.
2. Section 404(b) of the Sarbanes-Oxley Act requires auditors of public companies with market capitalization in excess of \$75 million to provide an opinion on the effectiveness of internal control.
3. Material weaknesses involve a reasonable possibility that a material misstatement of the financial statements will not be prevented or detected on a timely basis. Significant deficiencies are less severe than material weaknesses, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.
4. An integrated audit includes an audit report on both the financial statements and internal control. To issue such a report, the auditors perform procedures to test controls over all significant accounts, as well as substantive tests to support their opinion on the fairness of the financial statements.
5. Internal control audit reports are modified for one or more material weaknesses that exist at year-end. The report issued includes an adverse opinion indicating that effective internal control does not exist. If the scope of the auditors' work is limited, they should issue a disclaimer of opinion, or withdraw from the engagement.
6. After a client has remediated a material weakness that led to an adverse report, auditors may be engaged to attest to the elimination of the material weakness.

Key Terms Introduced or Emphasized in Chapter 18

Accounting estimate (838) Approximations used in a company's financial statements when there is an inherent lack of precision of measurement (estimation uncertainty). These approximations rely upon management's judgments or assumptions, such as determining the allowance for doubtful accounts, establishing warranty reserves, and assessing assets for impairment. We will consider the term *estimation uncertainty* synonymous with the term *measurement uncertainty*.

As of date (835) An audit of internal control over financial reporting assesses internal control as of a particular point in time, the "as of" date, as opposed to the entire period under audit. This date is ordinarily the last day of the client's fiscal period.

Compensating control (832) A control that reduces the risk that an existing or potential control weakness will result in a failure to meet a control objective (e.g., avoiding misstatements). Compensating controls are ordinarily controls performed to detect the misstatement, rather than prevent the misstatement from occurring. For example, a reconciliation of the bank account performed by an individual otherwise independent of the cash function serves to detect a variety of possible misstatements (both errors and fraud) that may have occurred in the processing of cash receipts and disbursements.

Complementary controls (840) Controls that function together to achieve the same control objective (e.g., avoiding misstatements).

Control deficiency (831) A weakness in the design or operation of a control that does not allow management or employees, in the normal course of performing their functions, to prevent or detect misstatements on a timely basis.

Detective controls (844) Policies and procedures that are designed to identify errors or fraud after they have occurred. Detective controls can be applied to groups of transactions (e.g., bank reconciliations).

Integrated audit (under PCAOB AS 2201) (829) An audit in which auditors, in addition to an opinion on the financial statements, express an opinion on the effectiveness of a company's internal control over financial reporting, in accordance with PCAOB AS 2201. Public companies with a market capitalization of \$75,000,000 or more are required to undergo integrated audits.

Major classes of transactions (832) Classes of transactions that materially affect significant financial statement accounts—either directly through entries in the general ledger or indirectly through the creation of rights or obligations that may or may not be recorded in the general ledger.

Management review control (842) Reviews conducted by management of estimates and other kinds of financial information for reasonableness. They often involve the use of significant judgment, knowledge, and experience in comparing recorded amounts with expectations of the reviewers. They often are considered monitoring controls but may relate to any of the other COSO components that have the common characteristic of management review of information to identify misstatements or breakdowns in other controls.

Material weakness (831) A control deficiency, or a combination of control deficiencies, in internal control over financial reporting, such that there is a *reasonable possibility* that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

Nonroutine transaction (838) A transaction that occurs only periodically, such as counting and pricing inventory, calculating depreciation expense, or determining prepaid expenses.

Preventive controls (844) Procedures designed to prevent an error or fraud. Preventive controls are normally applied at the individual transaction level.

Redundant controls (840) Duplicate controls that both achieve a control objective.

Relevant assertion (835) A financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion is made without regard to the effect of controls.

Routine transaction (838) A transaction for a recurring financial activity recorded in the accounting records in the normal course of business, such as sales, purchases, cash receipts, cash disbursements, and payroll.

Sarbanes-Oxley Act of 2002 (830) An act passed by the U.S. Congress to protect investors from the possibility of fraudulent accounting activities by corporations by improving the accuracy and reliability of corporate disclosures.

Section 404 (829) The primary section of the Sarbanes-Oxley Act dealing with management and auditor reporting on internal control over financial reporting. Section 404(a) requires that each annual report filed with the Securities and Exchange Commission include an internal control report prepared by management in which management acknowledges its responsibility for establishing and maintaining adequate internal control and an assessment of internal control effective *as of the end of the most recent fiscal year*. Section 404(b) requires that the CPA firm attest to and report internal control.

Significant accounts and disclosures (838) In the PCAOB auditing standards, accounts or disclosures that include one or more relevant assertions. The determination of significance is made before consideration of any related controls (that is, it is determined based on the assessment of inherent risk). Accordingly, an account or disclosure is considered significant when it has an *identified risk of material misstatement* at the assertion level (that is, there are one or more relevant assertions). The AICPA standards refer to this concept as significant account balances, classes of transactions, and disclosures.

Significant deficiency (831) A deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

Walk-through (840) A procedure in which an auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records, using the same documents and information technology that company personnel use. Walk-through procedures usually include a combination of inquiry, observation, inspection of relevant documentation, and reperformance of controls.

Review Questions

- 18–1. Section 404 of the Sarbanes-Oxley Act of 2002 includes two sections. Describe those sections.
- 18–2. Identify management's four overall responsibilities with respect to internal control over financial reporting that arise due to the Securities and Exchange Commission's implementation of the Sarbanes-Oxley Act of 2002.
- 18–3. What information must be included in management's report on internal control over financial reporting in the annual report filed with the Securities and Exchange Commission?

- 18-4. Describe the difference between a significant deficiency and a material weakness in internal control.
- 18-5. Comment on the accuracy of the following statement: "Because both significant deficiencies and material weaknesses must be reported to the audit committee, for practical purposes, there is no distinction between the two."
- 18-6. What is meant by the "as of" date when reporting on internal control over financial reporting?
- 18-7. What is a compensating control?
- 18-8. Provide examples of antifraud programs that the auditors might expect the client to have.
- 18-9. Describe what is meant by a "walk-through." Must walk-throughs be performed during audits of internal control over financial reporting? May the client perform a walk-through and the auditors then review the client's work?
- 18-10. While performing a walk-through, auditors ordinarily make certain inquiries of employees. Provide three examples of such inquiries.
- 18-11. Auditors often perform walk-throughs in integrated audits. Describe the evidence that is typically provided by a walk-through.
- 18-12. When performing an audit of internal control over financial reporting, auditors may distinguish among the following types of transactions: routine, nonroutine, and accounting estimates. Distinguish among these three types of transactions and give an example of each.
- 18-13. When performing an integrated audit, auditors should identify significant accounts and disclosures. What makes an account significant? What factors should be considered in deciding whether an account is significant?
- 18-14. A client operates out of 25 locations. Must the CPA perform tests related to internal control at each of these locations?
- 18-15. Comment on the following: "Auditors must decide, based on cost considerations, whether to test the design effectiveness or operating effectiveness of controls."
- 18-16. Provide an example of a situation in which the design of controls may be effective but those controls do not operate effectively.
- 18-17. Comment on the following: "Inquiry alone does not provide sufficient evidence to support the operating effectiveness of a control."
- 18-18. Comment on the following: "All controls should be tested either prior to or on the 'as of' date."
- 18-19. What requirements exist when the auditors use the work of client personnel as a part of the evidence obtained for an audit of internal control? In which areas of the audit would one expect this to be most likely to occur?
- 18-20. Provide an example of a situation in which the performance of substantive procedures for the financial statement audit might affect the internal control audit.
- 18-21. Provide an example of a situation in which the performance of tests of controls for the internal control audit might affect the performance of substantive procedures in a financial statement audit.
- 18-22. Distinguish between entity-level controls and controls designed to achieve specific control objectives.
- 18-23. Provide three examples of findings by the auditors that are at least significant deficiencies and strong indicators of the existence of a material weakness in internal control.
- 18-24. The auditors have completed an examination of internal control and are preparing to issue a report. Does the opinion paragraph on the client's internal control conclude on internal control or management's assessment of internal control?
- 18-25. What type of report on internal control is likely to be issued when management imposes a scope limitation?
- 18-26. If an adverse internal control report is issued by the auditors, may an unqualified report be issued on the financial statements?
- 18-27. Which types of deficiencies must be communicated to the audit committee?
- 18-28. Describe the requirements involved when auditors are engaged to report on whether a previously reported material weakness continues to exist.
- 18-29. Describe what is meant by applying a "top-down" approach to the audit of internal control over financial reporting.

Questions Requiring Analysis

LO 18-1, 5

Select questions are available with Connect.



- 18–30. Tests of controls are ordinarily performed for both financial statement audits and internal control audits.
- What is the objective of tests of controls when performed for internal control audits?
 - What is the objective of tests of controls when performed for financial statement audits?
 - How are these different objectives reconciled in an integrated audit?

LO 18-6

- 18–31. The CPA firm of Webster, Warren, & Webb LLP issued an adverse opinion on the internal control of Alexandria Financial, a public company, due to a material weakness. The weakness involved the lack of sufficient accounting expertise to evaluate and adopt appropriate accounting principles. Subsequent to issuance of the report, management of Alexandria hired a new controller to eliminate the weakness.
- Describe what steps Alexandria must perform to engage Webster, Warren, & Webb to issue a report indicating that the weakness no longer exists.
 - Describe how Webster, Warren, & Webb should approach the engagement.
 - Describe what Webster, Warren, & Webb must do if, during the course of the engagement, a member of the audit team discovers another material weakness in internal control over financial reporting. Will the new weakness affect the auditors' report?

LO 18-4, 5

- 18–32. The CPA firm Hank and Henry LLP is performing its first integrated audit of their recently acquired public client Wigly Corporation. Wigly has been in existence for 10 years. Wigly Corporation has two branch locations and has a monthly performed management review control of having the controller at each location test the existence, completeness, and valuation for various general and administrative expense accounts. Each month the controller of each branch compares the month's recorded expenses with the total for the preceding year. Any differences greater than 15 percent are investigated by the controller, who then summarizes the branch expense report and forwards it to the corporate chief financial officer. The report summarizes resolved and any unresolved issues. You are reviewing the work of your subordinate. Related documentation indicates that the subordinate (1) obtained an understanding of the procedure through an interview with the CFO and (2) selected a sample of monthly reports from each branch and
- Recalculated changes.
 - Considered the results of any changes for greater than 15 percent.

No exceptions were noted and a conclusion was arrived at that the control has been placed in operation and is operating effectively.

Provide overall comments as to the adequacy of the above procedures. What questions do you believe need to be answered prior to concluding on effectiveness of the control?

Objective Questions

LO 18-3

- 18–33. **Multiple Choice Questions** Select the best answer for each of the following questions. Explain the reasons for your selection:

- a. In an integrated audit, which of the following must the auditors communicate to the audit committee?

	Known Material Weaknesses	Known Significant Deficiencies
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

LO 18-6

- b. In an integrated audit, which of the following lead(s) to an adverse opinion on internal control?

	Known Material Weaknesses	Known Significant Deficiencies
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

LO 18-2

- c. In an integrated audit, which of the following must be communicated by management to the audit committee?

	Known Material Weaknesses	Known Significant Deficiencies
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

LO 18-6

- d. Which of the following is most likely to be considered a material weakness in internal control?

- (1) Ineffective oversight of financial reporting by the audit committee.
- (2) Restatement of previously issued financial statements due to a change in accounting principles.
- (3) Inadequate controls over nonroutine transactions.
- (4) Weaknesses in risk assessment.

LO 18-3

- e. Which of the following is defined as a weakness in internal control that allows a reasonable possibility of a misstatement that is material?

- (1) Control deficiency.
- (2) Material weakness.
- (3) Reportable condition.
- (4) Significant deficiency.

LO 18-6

- f. The auditors identified a material weakness in internal control in August. The client was informed and the client corrected the material weakness prior to year-end (December 31); the auditors concluded that management eliminated the material weakness prior to year-end. The appropriate audit report on internal control is:

- (1) Adverse.
- (2) Qualified.
- (3) Unqualified.
- (4) Unqualified with explanatory language relating to the material weakness.

LO 18-2

- g. Which of the following need *not* be included in management's report on internal control under Section 404(a) of the Sarbanes-Oxley Act of 2002?

- (1) A statement that the company's auditors have issued an audit report on management's assertion.
- (2) An identification of the framework used for evaluating internal control.
- (3) Management's assessment of the effectiveness of internal control.
- (4) Management's acknowledgment of its responsibility to establish and maintain internal control that detects all significant deficiencies.

LO 18-2

- h. Management's documentation of internal control ordinarily should include information on:

	Controls Designed to Prevent Fraud	Controls Designed to Ensure Employee Personal Integrity
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

LO 18-3

- i. A material weakness is a control deficiency (or combination of control deficiencies) that results in a reasonable possibility that a misstatement of at least what amount will not be prevented or detected?

- (1) Any amount greater than zero.
- (2) A greater amount than zero, but an amount that is at least inconsequential.
- (3) A greater amount than inconsequential.
- (4) A material amount.

LO 18-4

- j. A procedure that involves tracing a transaction from origination through the company's information systems until it is reflected in the company's financial report is referred to as a(n):
- (1) Analytical analysis.
 - (2) Substantive test.
 - (3) Test of a control.
 - (4) Walk-through.

LO 18-4

- k. Which of the following is *not* a typical question asked during a walk-through?
- (1) Have you ever been asked to override the process or controls?
 - (2) What do you do when you find an error?
 - (3) What is the largest fraudulent transaction you ever processed?
 - (4) What kind of errors have you found?

LO 18-4

- l. An audit of internal control over financial reporting ordinarily assesses internal control:
- (1) As of the last day of the fiscal period.
 - (2) As of the last day of the auditor's fieldwork.
 - (3) For the entire fiscal period.
 - (4) For the entire period plus the period of the auditor's fieldwork.

LO 18-4

- 18–34. While performing an internal control audit in conformity with PCAOB AS 2201, the auditors must be able to identify both control strengths and control weaknesses. Items (1) through (11) present various control strengths and deficiencies. For each item, select from the following list the appropriate response.
- A. Control strength for the revenue cycle (including cash receipts).
 - B. Control deficiency for the revenue cycle (including cash receipts).
 - C. Control strength unrelated to the revenue cycle.

Items to be answered:

1. Credit is granted by a credit department.
2. Sales returns are presented to a sales department clerk, who prepares a written prenumbered shipping report.
3. Statements are sent monthly to customers.
4. Write-offs of accounts receivable are approved by the controller.
5. Cash disbursements over \$10,000 require two signatures on the check.
6. Cash receipts received in the mail are received by a secretary with no record-keeping responsibility.
7. Cash receipts received in the mail are forwarded unopened, with remittance advices, to accounting.
8. The cash receipts journal is prepared by the treasurer's department.
9. Cash is deposited weekly.
10. Support for disbursement checks is canceled after payment by the treasurer.
11. Bank reconciliation is prepared by individuals independent of cash receipts record-keeping.

LO 18-4

18–35.

Simulation

Bill Jensen, a staff member of Zhan & Co., CPAs, has given you the following list of what he refers to as "internal control deficiencies" for the Zabbling Co. audit and has asked you to review each point and make certain that you agree that each is an internal control deficiency. For each of the following items, reply A (Agree) or D (Disagree) indicating whether the item represents an internal control deficiency.

- a. Voided checks are torn up and destroyed.
- b. Separate sequences of prenumbered checks are used for each bank account.
- c. The purchasing department manager and assistant manager are the authorized check signers.
- d. Checks are made payable to cash.
- e. The authorized check signers reconcile bank accounts.
- f. All cash receipts (checks) received through the mail are prelisted by the two individuals who open the mail.
- g. All cash receipts received through the mail are restrictively endorsed when received.
- h. When a disbursement is made based on paper supporting documents, those supporting documents are canceled by the individual who signs the check.

18–36. Adapted AICPA Simulation

During audits of internal control over financial reporting of various issuers, the auditors encountered the independent situations below. For each situation *a* through *e* select from the following list the appropriate audit responses. Each reply may be used once, more than once, or not at all.

1. Assess control risk as low for the purpose of the financial statement audit.
2. Consult legal counsel to explore reducing auditor liability.
3. Determine if the control deficiency is a material weakness by obtaining further evidence.
4. Disclose in the notes to the financial statements that there are material weaknesses.
5. Express an adverse opinion on internal control.
6. Express an unqualified opinion on internal control.
7. Express an unqualified opinion on internal control and add a paragraph on whether a previously reported material weakness in internal control continues to exist.
8. Insist that management's assessment of internal control includes a description of the significant deficiency.
9. Issue a disclaimer of opinion.
10. Issue a report on internal control stating that no deficiencies were noted.
11. Issue a separate report on the client's internal control.
12. Modify the opinion in the report on internal control for significant deficiencies.
13. Report matter only to the board of directors.

Situation	Response
<i>a.</i> The client did not furnish adequate evidence for the auditors to evaluate internal control over inventory. All other evidence was provided. <i>b.</i> The auditors examined the client's internal control over cash receipts and concluded that they are operating exactly as designed. However, the design of the controls does not include control procedures to prevent misstatements and the potential omission of cash receipts. <i>c.</i> The auditors concluded that the ineffectiveness of the design of controls over accounts payable and cash disbursements represents a material weakness in internal control, even though the financial statements are not materially misstated. <i>d.</i> The auditors concluded that a significant deficiency in internal control exists in the payroll function, but no material weakness. <i>e.</i> The auditor's prior-year report on internal control included an adverse opinion. The client has since modified internal control and no material weaknesses were found in the current year.	

LO 18-2, 3 4, 6 18–37. Match the following definitions (or partial definitions) to the appropriate term. Each term may be used once or not at all.

Definition (or Partial Definition)	Term
<i>a.</i> A control deficiency, or a combination of control deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis <i>b.</i> A weakness in the design or operation of a control that does not allow management or employees, in the normal course of performing their functions, to prevent or detect misstatements on a timely basis <i>c.</i> An account for which there is a reasonable possibility that it could contain misstatements that individually, or when aggregated with others, could have a material effect on the financial statements <i>d.</i> The primary section of the Sarbanes-Oxley Act dealing with management and auditor reporting on internal control over financial reporting <i>e.</i> Those transaction flows that have a meaningful bearing on the totals accumulated in the company's significant accounts and, therefore, have a meaningful bearing on relevant assertions <i>f.</i> Tracing a transaction from origination through the company's information systems until it is reflected in the company's financial reports	1. Control deficiency 2. Detective controls 3. Major classes of transactions 4. Material weakness 5. Nonroutine transaction 6. Routine transaction 7. Section 243 8. Section 404 9. Significant account 10. Significant deficiency 11. Substantive procedure 12. Walk-through

Problems LO 18-4

18–38.

Your working papers for an integrated audit being performed under PCAOB AS 2201 include the narrative description below of the cash receipts and billing portions of internal control of Slingsdale Building Supplies Inc. Slingsdale is a single-store retailer that sells a variety of tools, garden supplies, lumber, small appliances, and electrical fixtures to the public, although about half of Slingsdale's sales are to construction contractors on account. Slingsdale employs 12 salaried sales associates, a credit manager, three full-time clerical workers, and several part-time cash register clerks and assistant bookkeepers. The full-time clerical workers perform such tasks as cash receipts, billing, and accounting and are adequately bonded. They are referred to in the narrative as "accounts receivable supervisor," "cashier," and "bookkeeper."

Narrative:

Retail customers pay for merchandise by cash or credit card at cash registers when merchandise is purchased. A contractor may purchase merchandise on account if approved by the credit manager, based only on the manager's familiarity with the contractor's reputation. After credit is approved, the sales associate files a prenumbered charge form with the accounts receivable (AR) supervisor to set up the receivable.

The AR supervisor independently verifies the pricing and other details on the charge form by reference to a management-authorized price list, corrects any errors, prepares the invoice, and supervises a part-time employee who mails the invoice to the contractor. The AR supervisor electronically posts the details of the invoice in the AR subsidiary ledger; simultaneously, the transaction's details are transmitted to the bookkeeper. The AR supervisor also prepares a monthly computer-generated AR subsidiary ledger (without a reconciliation with the AR control account) and a monthly report of overdue accounts.

The cash receipts functions are performed by the cashier, who also supervises the cash register clerks. The cashier opens the mail, compares each check with the enclosed remittance advice, stamps each check "for deposit only," and lists checks for deposit. The cashier then gives the remittance advices to the bookkeeper for recording. The cashier deposits the checks daily, separate from the daily deposit of cash register receipts. The cashier retains the verified deposit slips, to assist in reconciling the monthly bank statements, but forwards to the bookkeeper a copy of the daily cash register summary. The cashier does not have access to the journals or ledgers.

The bookkeeper receives the details of transactions from the AR supervisor and the cashier for journalizing and posting to the general ledger. After recording the remittance advices received from the cashier, the bookkeeper electronically transmits the remittance information to the AR supervisor for subsidiary ledger updating. The bookkeeper sends monthly statements to contractors with unpaid balances upon receipt of the monthly report of overdue balances from the AR supervisor. The bookkeeper authorizes the AR supervisor to write off accounts as uncollectible when six months have passed since the initial overdue notice was sent. At this time, the credit manager is notified by the bookkeeper not to grant additional credit to that contractor.

- Based only on the information in the narrative, describe the internal control deficiencies in Slingsdale's internal control over the cash receipts and billing functions. Organize the weaknesses by employee job function: Credit manager, AR supervisor, Cashier, and Bookkeeper.
- Assume that you have performed your audit of internal control in conformity with PCAOB standards. Based on your results for requirement (a), you believe that several of the deficiencies represent material weaknesses. What effect will this have on your report on Slingsdale's internal control? Which types of opinions may be appropriate?
- What communication responsibilities do you have for any weaknesses that represent significant deficiencies?

In-Class LO 18-6
Team Cases

18–39.

For each of the following independent cases, state the highest level of deficiency that you believe the circumstances represent: a control deficiency, a significant deficiency, or a material weakness. Explain your decision in each case.

Case 1:

The company processes a significant number of routine intercompany transactions. Individual intercompany transactions are not material and primarily relate to balance sheet activity—for example, cash transfers between business units to finance normal operations. A formal management policy requires monthly reconciliation of intercompany accounts and confirmation of balances between business units. However, there is not a process in place to ensure performance of these procedures. As a result, detailed reconciliations of intercompany accounts are not performed on a timely basis. Management does perform monthly procedures to investigate selected large-dollar intercompany account differences. In addition,

management prepares a detailed monthly variance analysis of operating expenses to assess their reasonableness.

Case 2:

During its assessment of internal control over financial reporting, management identified the following deficiencies. Based on the context in which the deficiencies occur, management and the auditors agree that these deficiencies individually represent significant deficiencies:

- Inadequate segregation of duties over certain information system access controls.
- Several instances of transactions that were not properly recorded in the subsidiary ledgers; the transactions involved were not material, either individually or in the aggregate.
- No timely reconciliation of the account balances affected by the improperly recorded transactions.

Case 3:

The company uses a standard sales contract for most transactions, although sales personnel are allowed to modify sales contract terms as necessary to make a profitable sale. Individual sales transactions are not material to the entity. The company's accounting personnel review significant or unusual modifications to the sales contract terms, but they do not review changes in the standard shipping terms. The changes in the standard shipping terms could require a delay in the timing of revenue recognition. Management reviews gross margins on a monthly basis and investigates any significant or unusual relationships. In addition, management reviews the reasonableness of inventory levels at the end of each accounting period. The company has experienced limited situations in which revenue has been inappropriately recorded in advance of shipment, but amounts have not been material.

Case 4:

The company has a standard sales contract, but sales personnel frequently modify the terms of the contract. Sales personnel frequently grant unauthorized and unrecorded sales discounts to customers without the knowledge of the accounting department. These amounts are deducted by customers in paying their invoices and are recorded as outstanding balances on the accounts receivable aging. Although these amounts are individually insignificant, they are material in the aggregate and have occurred consistently over the past few years.

Case 5:

The company has found it necessary to restate its financial statements for the past two years due to a material overstatement of revenues two years ago (and an equal understatement last year). The errors are due to sales of certain software that allowed the purchasers extremely lenient rights of return. The errors were discovered shortly following the end of the current accounting year. Members of management indicated that the misstatements occurred because they simply didn't know the accounting rules. Now they know the rules and they won't let it happen again.

Case 6:

Assume the same facts exist as in Case 5 except that you, the auditor, have identified the misstatements at the end of June of the year currently under audit. Members of management acknowledged that the misstatements occurred because they simply didn't know the rules at the time, and now they know the rules. Management, within the last six months of the year under audit, hired a new financial accounting expert and believes that the control weakness has been corrected as of year-end. Management believes that it is extremely unlikely that such a misstatement could occur again with the new expert reviewing these matters.

Case 7:

Assume the same facts exist as in Case 6, except that management has informed the chief financial officer that she must watch over these matters much more carefully. She has attended several CPE courses on accounting and seems to be caught up in the area in which the misstatements occurred.

Case 8:

Subsequent to year-end, the auditors have determined that they believe that management has understated its warranty obligations. The auditors know that, according to the Professional Standards, they should consider the difference between management's estimate and the closest reasonable estimate as "likely misstatement." The chief financial officer (CFO) has argued that this amount is reasonable. Yet, in fact, neither the auditors nor the CFO knows which amount is right. The CFO is under no particular pressure to meet an earnings forecast; he just thinks that the warranty obligations for many of the products will expire and will not be exercised. Still, the CFO can't convince the auditors. Likewise, the auditors can't convince the CFO of their position. The CFO finally agrees to a material adjustment to get to the auditors' amount and "keep the peace."

(Adapted from PCAOB AS 2201)

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Additional Assurance Services: Historical Financial Information

In the preceding chapters, we emphasized the audit of financial statements prepared in accordance with accounting principles generally accepted in the United States, including resulting audit reports and communications to those charged with corporate governance. In addition, in Chapters 7 and 18 we discussed the audit of internal control over financial reporting. These services represent the CPAs' principal type of attestation engagements. However, CPAs provide additional communications related to these audits and perform a variety of other types of assurance, attestation, and accounting services.

Chapter 19 begins with a discussion of services that use the financial statement audit as a starting point but result in providing assurance on additional information. Next, we describe engagements that involve audits of information prepared using a financial reporting framework other than GAAP. Then we provide a summary of several assurance services not discussed previously in the text. Finally, we present a discussion of financial statement compilation and preparation services in which no assurance is provided by CPAs.

Audit-Based Services: Assurance on Additional Information

LO 19-1

Discuss additional audit-based services, including reporting on compliance with contractual agreements, letters for underwriters, and summary financial statements.

Auditors who have audited the financial statements of an organization are sometimes asked to use the audit results as a starting point for providing assurance on additional subject matter. Here we discuss reporting situations in which an audit has been performed and the auditors are engaged to (1) report on compliance with contractual or regulatory requirements, (2) issue a letter for underwriters, or (3) report on summary financial information.

Reporting on Compliance with Aspects of Contractual Agreements or Regulatory Requirements in Connection with Audited Financial Statements

Regulatory requirements and debt agreements often require companies to provide compliance reports prepared by their independent auditors. A common example of such reports is one prepared for a bond trustee as evidence of the company's compliance with restrictions contained in the bond indenture. The auditors typically provide a report indicating whether anything came to their attention with respect to the client's compliance with indenture provisions relating to matters such as the maintenance of certain financial ratios and restrictions on the payment of dividends.

Professional standards indicate that to provide this service, the auditors *must first have performed an audit* of the related financial statements and must have

subjected the applicable restrictions to audit procedures applied in the financial statement audit (AICPA AU-C 806; PCAOB AS 3305). The auditors may provide such assurance either in the audit report accompanying the financial

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 19-1** Discuss additional audit-based services, including reporting on compliance with contractual agreements, letters for underwriters, and summary financial statements.
- LO 19-2** Identify the types of special-purpose financial reporting frameworks and the nature of the audit reports issued.
- LO 19-3** Describe the auditors' responsibilities when auditing financial statements that use a generally accepted financial reporting framework of another country.
- LO 19-4** Describe the nature of audits of employee benefit plans subject to the requirements of the Employee Retirement Income Security Act of 1974.
- LO 19-5** Discuss engagements involving single financial statements and specific accounts or items of a financial statement.
- LO 19-6** Explain the special considerations involved in auditing personal financial statements.
- LO 19-7** Describe the nature of financial statement reviews conducted under *Statements on Standards for Accounting and Review Services*.
- LO 19-8** Discuss how reviews performed under *Statements on Standards for Accounting and Review Services* differ from those performed under the *Statements on Auditing Standards*.
- LO 19-9** Explain the accountant's responsibilities when compiling and preparing financial statements.

statements or in a separate report. When a separate report is issued, it includes an introductory paragraph summarizing the audit report on the financial statements, a paragraph indicating their findings with respect to compliance, and a paragraph indicating that the report is solely for the use of the client and the specified third party. The following paragraph illustrates the nature of the assurance expressed by the auditors in these reports.

In connection with our audit, nothing came to our attention that caused us to believe that the Company was not in compliance with any of the terms, covenants, provisions, or conditions of Sections 8 to 15, inclusive, of the Indenture dated July 21, 20X1, with First National Bank, insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance. Accordingly, had we performed additional procedures, other matters may have come to our attention regarding the Company's noncompliance with the above-referenced terms, covenants, provisions, or conditions of the Indenture, insofar as they relate to accounting matters.

The above conclusion, “nothing came to our attention,” is referred to as **negative assurance**. When the auditors have identified one or more incidences of noncompliance that they believe should be reported, the items should be identified in the report. Also, issuance of this type of report is not appropriate if the auditors have expressed an adverse opinion or disclaimed an opinion on the financial statements to which the compliance relates. Chapter 20 provides additional types of compliance attestation engagements.

Letters for Underwriters

Investment banking firms that underwrite securities issues often request independent auditors who have audited the financial statements and schedules in the registration statement to issue a letter for the underwriters. This letter is commonly called a **comfort letter**, and the professional standards provide guidance on its content (AICPA AU-C 920; PCAOB AS 6101). The standards indicate that a comfort letter may include assurance about the following matters:

1. The auditors' independence in conformity with SEC requirements.
2. Whether the audited financial statements and financial statement schedules included in the registration statement comply regarding form with the accounting requirements of the Securities Act of 1933 and related regulations.
3. Unaudited financial statements, condensed interim financial information, capsule financial information, pro forma financial information, financial forecasts, and management's discussion and analysis.
4. Changes in selected financial statement items during a period subsequent to the date and period of the latest financial statements included in the registration statement.
5. Tables, statistics, and other financial information included in the registration statement.
6. Certain nonfinancial statement information included in the registration statement complies regarding form with SEC regulations.

Auditors may provide positive assurance on items 1 and 2 of the preceding list. For items 3 through 6, auditors are often able to provide negative assurance. This negative assurance indicates that, based on the procedures performed, nothing has come to their attention to cause them to believe that any material modifications need to be made to the information, or nothing came to their attention that indicated the information does not materially comply with SEC requirements.

Comfort letters aid the underwriters in fulfilling their obligation to perform a reasonable investigation of the securities registration statement. No definitive criteria exist for the underwriters' “reasonable investigation.” Therefore, the underwriters should approve the adequacy of the CPAs' procedures serving as a basis for the comfort letter.

Summary Financial Statements

Occasionally, a client-prepared document will include **summary financial statements (condensed financial statements)** developed from audited financial statements. These statements typically include considerably less detail than the audited financial



Illustrative Case

Summary Annual Reports

A number of corporations have experimented with issuing summary annual reports to shareholders. These reports generally include condensed financial statements and refer shareholders desiring more detailed

information to the annual report filed with the SEC (Form 10-K). The auditors of these companies issue a report on the summary financial statements that refers to their report included with the Form 10-K.

statements. The auditors who issued the report on the audited financial statements may be asked to report on the summary statements. Unless they have issued an adverse opinion or a disclaimer of opinion on the audited financial statements, the auditors may accept an engagement related to the summary financial statements (AICPA AU-C 810; PCAOB AS 3315). In these circumstances, the auditors determine whether the criteria applied by management in the preparation of the summary financial statements are acceptable and whether those criteria have been properly applied. Although they need not accompany the summary financial statements, the audited financial statements should be readily available to any user who wishes to obtain them (e.g., available on the company's website). When the CPAs have concluded that the summary financial information is properly presented, they may issue an opinion stating that the summary financial statements are consistent, in all material respects, with the financial statements from which they have been derived.

Auditing Financial Statements That Use a Financial Reporting Framework Other Than GAAP

Recall that in Chapter 1 we briefly discussed **financial reporting frameworks**, which are sets of criteria for preparing financial statements (e.g., generally accepted accounting principles are referred to as a **general-purpose financial reporting framework**). Auditors are sometimes engaged to audit financial statements that are prepared using a financial reporting framework *other than* generally accepted accounting principles. In this section, we describe special-purpose frameworks and frameworks used in a foreign country.

Audits of Financial Statements Prepared in Accordance with Special-Purpose Financial Reporting Frameworks

LO 19-2

Identify the types of special-purpose financial reporting frameworks and the nature of the audit reports issued.

The professional standards (AICPA AU-C 800) define **special-purpose financial reporting frameworks** as including (a) cash basis, (b) tax basis, (c) contractual basis, (d) regulatory basis, and (e) other basis.¹

When considering acceptance of an engagement in which a special-purpose financial reporting framework is used, the auditors should obtain an understanding of the purpose of the financial statements, the intended users, and steps taken by management to determine that the framework is acceptable in the circumstances. In addition, management must acknowledge that it understands its responsibilities with respect to the framework. When planning and performing the audit, the auditors adapt auditing standards that are relevant in the circumstances.

An audit report on financial statements prepared using a special-purpose financial reporting framework departs from the standard form in several ways. Most importantly, the report must include an Emphasis of Matter section that states that the financial statements are prepared using a special-purpose framework that is a basis of accounting other than GAAP. The section also should describe the basis of accounting being used or refer

¹ Under the current PCAOB standard (AS 3305), the cash basis, tax basis, and regulatory basis financial reporting frameworks are referred to as "other comprehensive bases of accounting."

to a financial statement note that provides a description of the basis. The essence of the report is the expression of an opinion about whether the financial statements are fairly presented based on the described basis of accounting.

The auditors should be cautious about the titles given to the financial statements. Titles such as “balance sheet,” “income statement,” and “statement of cash flows” are generally associated with financial statements presented in accordance with GAAP. Consequently, the professional standards require more descriptive titles for statements that are presented on some other basis. For example, a cash-basis “balance sheet” is more appropriately titled “statement of assets and liabilities arising from cash transactions.” Following are the Opinion and Emphasis of Matter sections of an unmodified report on cash-basis statements with the distinctive wording emphasized.

Opinion

We have audited the financial statements of XYZ Partnership, which comprise the *statement of assets and liabilities arising from cash transactions* as of December 31, 20X1, and the related *statement of revenue collected and expenses paid* for the year then ended, and the related notes to the financial statements.

In our opinion, the accompanying financial statements present fairly, in all material respects, the assets and liabilities arising from cash transactions of XYZ Partnership as of December 31, 20X1, and its revenue collected and expenses paid during the year then ended in accordance with the *cash basis of accounting described in Note X*.

Basis for Opinion [same as in Chapter 17 unmodified opinion illustration]

Emphasis of Matter—Basis of Accounting

We draw attention to Note X of the financial statements, which describes the basis of accounting. The financial statements are prepared on the *cash basis of accounting, which is a basis of accounting other than accounting principles generally accepted in the United States of America*. Our opinion is not modified with respect to this matter.

If the special-purpose financial statements are prepared in accordance with a contractual or regulatory basis of accounting, the auditors’ report also should include two additions. First a sentence such as the following is added before the final sentence in the Emphasis of Matter section: “As a result, the financial statements may not be suitable for another purpose.” Second, an Other Matter section alerting users about the intended use of the auditors’ report is added (e.g., for those within the entity, the parties to the contract or agreement, or the applicable regulatory agency). The following is an illustration of this section relating to a regulatory agency:

Other Matter—Restriction on Use

Our report is intended solely for the information and use of ABC Governmental Agency and is not intended to be and should not be used by parties other than this party.

Figure 19.1 provides overall reporting requirements relating to the various special-purpose frameworks.

Auditors’ Report Prescribed by Law or Regulation

When the auditors are involved with financial information prepared on a regulatory basis, they may be requested to use a specific layout, form, or wording (hereafter, layout) for the auditors’ report. If the layout includes the basic reporting requirements (e.g., title, addresses, management and auditor responsibilities, opinion paragraph), they may use it. If the layout is not acceptable, or would cause the auditors to make a statement they have no basis to make, they should reword it or attach an appropriately worded separate report. If this is not allowable, the auditors should not accept the audit engagement unless required by law or regulation to do so. If so required, the auditors should not include any reference within the auditors’ report to the audit having been conducted in accordance with GAAS.

FIGURE 19.1 Overview of Reporting Requirements

	Cash Basis	Tax Basis	Contractual Basis	Regulatory Basis	Regulatory Basis (General Use Statements)	Other Basis
Opinion(s)	Single opinion on special-purpose framework	Single opinion on special-purpose framework	Single opinion on special-purpose framework	Single opinion on special-purpose framework	Dual opinion on special-purpose framework and on GAAP	Single opinion on special-purpose framework
Description of purpose for which special-purpose financial statements are prepared	No	No	Yes	Yes	Yes	Yes
Emphasis-of-matter paragraph alerting readers to the preparation in accordance with a special-purpose framework	Yes	Yes	Yes	Yes	No	Yes
Other-matter paragraph including an alert about restricting the use of the auditors' report	No	No	Yes	Yes	No	Yes
Additional requirements unique to category			The auditors must obtain an understanding of significant management interpretations of the contract.	If a specific layout, form, or wording is required that the auditors have no basis to make, then the auditors should reword the form or attach an appropriately worded separate report.		

Financial Statements Prepared Using a Financial Reporting Framework Generally Accepted in Another Country

LO 19-3

Describe the auditors' responsibilities when auditing financial statements that use a generally accepted financial reporting framework of another country.

A U.S.-based company may prepare financial statements using another country's financial reporting framework (rather than U.S. GAAP) for use in that country. For example, a company may have a subsidiary in Germany and may prepare financial statements for that subsidiary following German accounting principles as part of an effort to raise capital in Germany. The professional standards (AICPA AU-C 910) address the auditors' responsibility in this situation. When auditing the information, the auditors should comply with U.S. auditing standards to the extent the standards are appropriate. In addition, the auditors should obtain an understanding of the other country's financial reporting framework. Also, if the terms of the engagement require the auditors to apply either the auditing standards of that country or the international standards, the auditors should apply those standards.

When the financial statements are *intended for use only outside* the United States, the auditors should issue one report, using either

- A U.S. form of report that indicates that the financial statements have been prepared in accordance with a financial reporting framework generally accepted in another country or
- The audit report appropriate in the other country.

When the financial statements are also intended for use in the United States, the auditors use a U.S. form of report. This report includes an emphasis-of-matter paragraph stating the financial reporting framework used and that it differs from GAAP; an unmodified opinion may be issued indicating that the financial statements are presented in accordance with the financial reporting framework used.

Additional GAAS Audits and Other Types of Assurance Engagements

In this section, we describe CPA association with

- Financial statements of employee benefit plans.
- Single financial statements (e.g., an income statement, and not the other financial statements), and specific elements, accounts, or items of financial statement (e.g., a schedule of accounts receivable).
- Personal financial statements.

Audits of Financial Statements of Employee Benefit Plans

LO 19-4

Describe the nature of audits of employee benefit plans subject to the requirements of the Employee Retirement Income Security Act of 1974.

As discussed briefly in Chapter 2, AICPA Auditing Standards Board AU-C 703 presents specialized standards for the audit of the financial statements of employee benefit plans (plan financial statements) filed under the requirements of the **Employee Retirement Income Security Act of 1974 (ERISA)**. In broad terms, an employee benefit plan (plan) is an employer-sponsored *retirement plan* or an employer-sponsored health plan (e.g., health insurance plan). Audits of a plan's financial statements are performed in accordance with the AICPA Auditing Standards Board because the plans are generally considered nonpublic, even if they are offered to employees and retirees by a public company.²

The requirements of ERISA apply to most qualified retirement plans and certain welfare benefit plans established by private organizations. The law requires covered plans with at least 100 participants to submit audited plan financial statements with their Form 5500 that must be filed annually with the U.S. Department of Labor.

In performing the audits of these plans, the auditors follow generally accepted auditing standards with modifications, including

- **Obtaining an understanding and assessing risks of material misstatement.** The auditors should read the current plan instrument and effective amendments for provisions that affect the risk of material misstatement. They also should consider whether management has performed the compliance tests required by the Internal Revenue Code, including tests to determine whether the plan is discriminating in favor of highly compensated employees.
- **Obtaining client representations.** The auditors should obtain additional representations from management indicating that management is responsible for maintaining the plan instrument (including all plan amendments) and administering it, including determining that its transactions are presented in conformity with the plan's provisions.
- **Performing further audit procedures and forming an opinion.** The auditors evaluate whether any prohibited transactions identified by management or identified during the audit have been appropriately reported in the applicable ERISA-required supplemental schedule. If the effects of any of the unreported transactions are material, the auditors must modify their opinion on the plan financial statements. If the effects of any unreported transactions are not material to the plan financial statements, the auditors should describe the matter in an other-matter paragraph of the auditors' report.

² Employee benefit plans that include their company's securities in employee stock purchase, savings, or similar plans are generally required to file a Form 11-K with the Securities and Exchange Commission (in addition to Department of Labor requirements). Form 11-K requires the filing of audited financial statements of audits performed following PCAOB standards. Accordingly, for such plans, auditors perform their audits in accordance with both GAAS and PCAOB standards and prepare an additional audit report for that Form 11-K requirement.

Also, the auditors should communicate instances of noncompliance or suspected noncompliance with laws and regulations to those charged with governance of the plan.

- **Affirming auditor independence.** When auditing an employee benefit plan, the auditors must follow both AICPA auditor independence rules and independence standards of the U.S. Department of Labor (DOL). Although requirements are very similar, one area that causes particular concern is auditor financial interests in the sponsoring company and its plan. The DOL rules indicate that an accountant is not independent if the accountant, the accounting firm, or a member of the firm has acquired or is committed to acquire a direct or material indirect interest in either the plan or the plan sponsor. Under these requirements, the firm members that must be independent include all partners, the professional staff working on the engagement, and professional staff assigned to the operating group performing the audit. This is slightly more individuals than the “covered members” under the independence rules of the AICPA. Also, while AICPA standards allow the provision of bookkeeping services for a plan, DOL rules consider independence impaired if the firm or any of its employees “maintain the financial records” of an employee benefit plan. Similar to the AICPA rules, the independence issue may be resolved by disposing of the interest before the period of the engagement.

ERISA Section 103(a)(3)(C) Audits

A more limited audit is available to certain plans under ERISA. ERISA Section 130(a)(3)(C) allows management to elect to exclude from the audit certain information about investments held by a *qualified institution* that has certified that the information is complete and accurate. A **qualified institution** is one that is regulated and subject to periodic examination by a state or federal agency such as a bank, trust company, or similar institution (e.g., an insurance company). The management of most plans that use such an institution select this type of audit.

ERISA Section 130(a)(3)(C) audits were previously referred to as “limited-scope audits.” In performing the audits, the auditors should

1. Evaluate management’s assessment of whether the certifying institution is a qualified institution under Department of Labor rules and regulations.
2. Compare the certified information to the related information presented in the plan financial statements and determine that the certified investment information is presented in accordance with the applicable financial reporting framework.
3. Perform audit procedures on plan financial statement information not covered by the certification.
4. Perform procedures to determine that received and disbursed amounts reported by the certifying institution were determined in accordance with plan provisions.
5. Obtain representations of management that the auditors have been provided with the most current plan instrument and amendments, management is responsible for administering the plan in accordance with the plan’s provisions, and electing a ERISA Section 103(a)(3)(C) audit is appropriate in the circumstances.

In all audits of employee benefit plans, the auditors are required to read the plan’s Form 5500 for inconsistencies with information in the plan financial statements or other misstatements of fact. If they discover a misstatement in Form 5500 that management refuses to correct, they should communicate the matter to those charged with governance and (a) describe the matter in an other-matter paragraph of the report, (b) withhold the auditors’ report, or (c) if allowed, withdraw from the engagement.

Audit Reports on Employee Benefit Plans

In general, audit reports on employee benefit plans are similar to audit reports on other types of entities. The auditors provide an opinion on whether the plan financial statements are presented, in all material respects, in accordance with generally accepted accounting principles (GAAP). However, there are several additional requirements. The section of the report on management’s responsibilities should indicate that management is responsible for

maintaining a current plan instrument, including all plan amendments, and for administering the plan and presenting transactions in conformity with the plan's provisions. In addition, the auditors are required to report on whether the ERISA-required schedules are fairly stated, in all material respects, in relation to the plan financial statements as a whole.

In summary, the auditors' report provides the following assurances:

1. An audit opinion on the overall financial statements on whether the financial statements are presented fairly in accordance with GAAP.
2. A statement, in a separate section of the report, on whether the schedules are fairly stated in relation to the financial statements as a whole following DOL requirements.

As indicated above, the auditors may perform an ERISA Section 103(a)(3)(C) audit. For this type of audit, the auditors audit the financial statements but rely upon the qualified institution's certification for verification of the plan's investment assets. In these circumstances, the auditors' report is modified to include a first section titled "Scope and Nature of the ERISA Section 103(a)(3)(C) Audit," which indicates that management has elected to have that type of audit, management has obtained a certification from the qualified financial institution stating the investment information is complete and accurate, and the audit does not extend to any information related to investments held by the institution.

While their opinion on other portions of the financial statements is standard, for the investment assets the audit opinion indicates that the auditors have determined that the assets are held by the institution agreed to or are derived from the certified investment information provided by the qualified institution. Presented below is an abstract of a Section 103(a)(3)(C) audit report.

Report of the Independent Auditors

The Retirement Committee
Blue Corporation
Phoenix, AZ 85001

Scope and Nature of the ERISA Section 103(a)(3)(C) Audit

We have performed audits of the financial statements of Blue Corporation's 401(k) Plan, an employee benefit plan subject to the Employee Retirement Income Security Act of 1974 (ERISA), as permitted by ERISA Section 103(a)(3)(C). The financial statements comprise the statements of net assets available for benefits as of December 31, 20X2 and 20X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2, and the related notes to the financial statements. Management, having determined it is permissible in the circumstances, has elected to have the audits of Blue Corporation 401(k) Plan's financial statements performed in accordance with ERISA Section 103(a)(3)(C) pursuant to 29 C.F.R. § 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under ERISA. *As permitted by ERISA Section 103(a)(3)(C), our audits did not extend to any statements or information related to assets held for investment of the plan and certified to by XYZ Bank.*

Management has obtained certifications from XYZ Bank as of December 31, 20X2 and 20X1, and for the year ended December 31, 20X2, stating that the certified investment information, as described in Note X to the financial statements, is complete and accurate.

Opinion

In our opinion, based on our audits and on the procedures performed as described in the Auditor's Responsibilities for the Audit of the Financial Statements section:

- the amounts and disclosures in the accompanying financial statements, other than those agreed to or derived from the certified investment information, are presented fairly, in all material respects, in accordance with accounting principles generally accepted in the United States of America, and
- the information in the accompanying financial statements related to assets held by and certified to by a qualified institution agrees to, or is derived from, in all material respects, the information prepared and certified by an institution that management determined meets the requirements of ERISA Section 103(a)(3)(C).

[Basis for Opinion Section]

[Management Responsibility Section]

[Auditor Responsibility Section]

Other Matter Section on Any ERISA-Required Schedules

In our opinion

- the form and content of the supplemental schedules, other than the information in the supplemental schedules that agrees to or is derived from the certified investment information, are presented, in all material respects, in conformity with the Department of Labor's Rules and Regulations for Reporting and Disclosure under ERISA.
- the information in the supplemental schedules related to assets held by and certified to by a qualified institution agrees to or is derived from, in all material respects, the information prepared and certified by an institution that management determined meets the requirements of ERISA Section 103(a)(3)(C).

Single Financial Statements and Specific Elements, Accounts, or Items of Financial Statements

LO 19-5

Discuss engagements involving single financial statements and specific accounts or items of a financial statement.

Auditors may be engaged to audit a single financial statement or a specific element, account, or item (hereafter, element) of a financial statement (AICPA AU-C 805). A company may request the audit because it has entered into an agreement such as

- A loan agreement that includes a requirement that the balance sheet (but not other financial statements) be audited annually.
- A lease agreement with a requirement that annual company revenues be audited because lease payments are based in part on the lessee's revenue.

When auditing a single financial statement or a specific element of a financial statement, the auditors should adapt GAAS to the extent necessary in the circumstances and then apply it. The auditors should perform procedures on interrelated items as necessary to meet the objectives of the audit. Examples of interrelated items include sales and receivables, inventory and payables, and building and equipment and depreciation. Thus, when auditing the sales account, the auditors will normally need to perform procedures on accounts receivable.

When the CPAs are engaged to audit a particular account or element, they modify the audit report to indicate the information audited, the basis of accounting used, and whether the information is presented fairly on that basis. For example, the following represents the Opinion section of a report on the audit of accounts receivable.

Opinion

We have audited the schedule of accounts receivable of MNO Company as of December 31, 20X1, and the related notes (the schedule).

In our opinion, the accompanying schedule presents fairly, in all material respects, the accounts receivable of MNO Company as of December 31, 20X1, in accordance with accounting principles generally accepted in the United States of America.

In some situations, the auditors may be engaged to report on a schedule of accounts that are not on the balance sheet, income statement, or statement of cash flows, but otherwise are prepared in accordance with GAAP. Examples of such schedules include

- A governmental agency may require a schedule of gross income and certain expenses of a company's real estate operation in which income and expenses are measured in accordance with GAAP, but expenses are defined to exclude certain items such as interest, depreciation, and income taxes.
- An agreement in which one company is considering acquiring another company may specify a schedule of gross assets and liabilities of the company measured in accordance with GAAP, but limited to the assets to be sold and liabilities to be transferred according to the agreement.

In these situations, the auditors' report should include an Emphasis of Matter section stating the purpose of the presentation, referring to a note that describes the basis of the presentation, and stating that the presentation is not intended to be a complete presentation of the organization's assets, liabilities, revenues, or expenses.

To this point we have discussed situations in which auditors are asked to audit information that is less than a complete set of financial statements. In some circumstances, when they have performed an audit of the complete set of financial statements, they also may be asked to audit and report on a single financial statement or element. In such circumstances:

- A separate opinion should be issued for each engagement.
- Different materiality measures will ordinarily be used for the two engagements (e.g., materiality for a particular element generally will be less than for the overall financial statements).
- When both the complete set of financial statements and the single financial statement (or element) are being published together, the auditors must be satisfied that there is a clear differentiation between them.
- When the auditors' report on the complete set of financial statements is modified, the auditors should consider its effect on the single financial statement (or element) report. When the matter relates to the specific element, the report on the element is also likely to be modified. When it does not relate to the specific element, it may be possible to issue an unmodified report on the element if the two reports are not published together and the specific element does not constitute a major portion of the complete set of financial statements.

Reviews and Agreed-Upon Procedures Engagements

On occasion, a client may not require an audit of a complete set of financial statements but, instead, may engage a CPA to *review*, or perform *agreed-upon procedures* on, a financial statement or specified elements of financial statements. As an example, assume that a company entering bankruptcy proceedings requests its CPAs to perform review procedures (analytical procedures and inquiry procedures) related to the claims of creditors. CPAs may perform such a service and issue a report with limited assurance, that is, assurance short of that provided in an audit. Reviews are presented later in this chapter.

Alternatively, a CPA may be engaged to perform **agreed-upon procedures** on specified elements, accounts, or items of financial statements. The attestation standards provide guidance for these engagements that result in a report with a summary of procedures performed and findings (AICPA AT-C 215; PCAOB AT 201). Agreed-upon procedures engagements are “customer driven” services in that the **engaging party** and the CPAs determine the procedures to be performed. As applied to the bankruptcy example, the company would affirm that the procedures are appropriate to meet the engagement's intended purpose. To illustrate, assume the client and the CPAs agree that the CPAs will perform the following procedures relating to the creditor claims: (1) agreeing total payables per the trial balance to the related general ledger account, (2) obtaining creditor claim forms in support of amounts claimed by creditors and comparing creditor name and amounts to the accounts payable trial balance, and (3) comparing the claim forms to invoices and receiving reports provided by the company.

After the CPAs have obtained agreement as to the terms of the engagement, they perform the procedures and prepare an agreed-upon procedures report. The CPAs' report will indicate the intended purpose of the engagement, indicate that the procedures performed were acknowledged by the engaging party to be adequate for the purpose, and include a statement that the report may not be suitable for any other purpose. It will include a description of the findings from each procedure performed (e.g., exceptions noted while performing the procedures) and indicate that neither an examination nor a review was performed. The following is a nonpublic company illustrative agreed-upon procedures report:

Independent Accountant's Report

To XYZ Company and the Trustee of XYZ Company

We performed the procedures enumerated below on the claims of creditors of XYZ Company as of May 31, 20XX, as set forth in the accompanying Schedule A. XYZ Company is responsible for Schedule A and its underlying data.

XYZ Company has agreed to and acknowledged that the procedures performed are appropriate to meet the intended purpose of assisting users in understanding the claims of creditors of XYZ Company as of May 31, 20XX, as set forth in the accompanying Schedule A. Additionally, the Trustee of XYZ Company has agreed to and acknowledged that the procedures performed are appropriate to meet its purposes. This report may not be suitable for any other purpose. The procedures performed may not address all of the items of interest to a user of this report and may not meet the needs of all users of this report and, as such, users are responsible for determining whether the procedures performed are appropriate for their purposes.

The procedures and associated findings are as follows:

1. Obtained the general ledger and the accounts payable trial balance as of May 31, 20XX, from XYZ Company. Compared the total of the accounts payable trial balance to the total accounts payable balance in general ledger account number 481.

The total of the accounts payable trial balance agreed with the total accounts payable balance in the general ledger account number 481.

2. Obtained the claim form submitted by creditors in support of the amounts claimed from XYZ Company. Compared the creditor name and amounts from the claim form to the respective name and amounts shown in the accounts payable trial balance obtained in procedure 1. For any differences identified, requested XYZ Company to provide supporting detail. Compared such identified differences to the supporting detail provided.

All differences noted are presented in column 3 of Schedule A. Except for those amounts shown in column 4 of Schedule A, all such differences were agreed to [describe supporting detail].

3. Using the claim form obtained in procedure 2, compared the name and amount to invoices, and if applicable, receiving reports, provided by XYZ Company.

No exceptions were found as a result of this procedure.

We were engaged by XYZ Company to perform this agreed-upon procedures engagement in accordance with attestation standards established by the AICPA. We were not engaged to and did not conduct an examination or review engagement, the objective of which would be the expression of an opinion or conclusion, respectively, on the accompanying Schedule A. Accordingly, we do not express such an opinion or conclusion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

We are required to be independent of XYZ Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements related to our agreed-upon procedures engagement.

Smisak and Company, CPAs

June 23, 20XX

St. Louis, Missouri

In some cases, the CPA may consider it appropriate to add a separate paragraph that restricts the use of the practitioner's agreed-upon procedures report, such as the paragraph presented below:

This report is intended solely for the information and use of XYZ Company and the Trustee of XYZ Company, and is not intended to be, and should not be, used by anyone other than these specified parties.

Examples of other situations in which additional restrictions may be included are engagements in which

- The engaging party requests a restriction.
- Compliance with aspects of contracts is involved and the report is restricted to parties to the contract.
- The subject matter is only available to a limited number of parties.

Audits of Personal Financial Statements

LO 19-6

Explain the special considerations involved in auditing personal financial statements.

While not required, the CPA may request the additional parties to acknowledge that the procedures performed are appropriate for their intended purposes.³

Audited personal financial statements may be required in a variety of circumstances, including when an individual seeks a large loan or wishes to purchase a business using their personal credit. Generally accepted accounting principles applied to personal financial statements are quite different from those applicable to business entities. In personal financial statements, assets are shown at their *estimated current values* and liabilities are presented at their *estimated current amounts*. Thus, auditors must apply audit procedures that will substantiate these estimates. On occasion, the auditors may need to rely upon appraisers, following the guidelines set forth for using the work of a specialist (AICPA AU-C 620; PCAOB AS 1210).

The “balance sheet” for an individual is termed a *statement of financial condition*. This statement shows the individual’s *net worth* in lieu of “owners’ equity” and includes a liability for income taxes on the differences between the estimated current values of assets and liabilities and their income tax bases. The “income statement” for an individual is called the *statement of changes in net worth*. In addition to showing revenue and expenses, this statement includes the increases and decreases in both the estimated current values of assets and the estimated amounts of liabilities during the period. Audit reports issued on personal financial statements are similar to those presented in Chapter 17 but are modified for the change in financial statement titles.

Completeness—A Special Problem in Personal Financial Statements

One of the assertions that a client makes regarding its financial statements is that the statements are complete—that is, they reflect all of the client’s assets, liabilities, and transactions for the period. Determining the completeness of financial statements may be especially difficult in the audit of personal financial statements for several reasons. First, there is generally poor internal control because all aspects of each transaction usually are under the control of the individual. Second, some individuals may seek to omit assets and income from their personal financial statements. The motivation to conceal earnings or assets may stem from income tax or estate tax considerations, anticipation of a divorce, or illegal sources of income.

The omission of assets from financial statements is far more difficult for auditors to detect than is the overstatement of assets or omission of liabilities. Thus, in deciding whether to accept a personal financial statements audit engagement, auditors should assess the risk that an individual may be concealing assets. If auditors conclude during an engagement that the individual is concealing assets, it is doubtful that they can ever develop confidence that their audit procedures have located all the concealed assets. Therefore, they should withdraw from the engagement.

Most engagements involving personal financial statements are *not* audits because few individuals need audited financial statements. The approaches described for reviews, compilations, and financial statement preparation later in this chapter are more commonly applied to personal financial statements.

³ A discussion of agreed-upon procedures engagements can become quite involved. It is helpful to consider three “parties” involved:

- Engaging party—the party that hires the CPAs to perform the engagement (XYZ Company).
- Responsible party—the party responsible for the subject matter (XYZ Company).
- Specified parties—the intended users to whom use of the written practitioner’s report may be limited (XYZ Company and the trustee of XYZ Company).

CPA responsibilities are affected by the above parties (e.g., when the responsible party is not the engaging party, differing representations should be obtained from each). Also, details of the engagement will resolve whether the engaging party is a particular individual or the company itself. Many such issues exist as the procedures and requirements of the standard get quite involved and are beyond the scope of this brief overview of agreed-upon procedures engagements.

Reviews of Historical Financial Statements

In this section, we consider reviews of historical financial statements performed under

- AICPA *Statements on Standards for Accounting and Review Services (SSARS)*—ordinarily for nonpublic company annual financial statement or financial information reviews.
- AICPA *Statements on Auditing Standards*—ordinarily for nonpublic company interim financial statement reviews when the company has an annual audit.
- PCAOB *Auditing Standards*—for public company interim financial statement reviews (an audit ordinarily is required of annual financial statements).

The professional standards for reviews are very detailed. Our approach is to present important general information that is less detailed than our coverage of financial statement audits. Also, we will limit our discussion of reviews to financial statements prepared following generally accepted accounting principles.⁴

SSARS Reviews of Nonpublic Companies (Nonissuers)

LO 19-7

Describe the nature of financial statement reviews conducted under *Statements on Standards for Accounting and Review Services*.

Serving the needs of small business represents a sizable part of the practice of many public accounting firms. For a smaller public accounting firm, nonpublic clients may represent the firm's entire practice. To provide CPAs with guidance in meeting the accounting needs of these nonpublic (**nonissuer**) clients, the AICPA established the Accounting and Review Services Committee. This committee sets professional standards for CPAs associated with the *unaudited* financial statements, or other unaudited historical financial information of nonpublic companies. These standards are published in a sequentially numbered series called *Statements on Standards for Accounting and Review Services (SSARS)*. The SSARS include guidance for three types of engagements involving unaudited financial statements of nonpublic companies: **reviews** (AICPA AR-C 90), **compilations** (AICPA AR-C 80), and **preparation of financial statements** (AICPA AR-C 70). Compilation and financial statement preparation services are described in detail in the final section of this chapter.

We will refer to reviews performed under these standards as “SSARS reviews,” to distinguish them from reviews of interim information performed under the requirements of the PCAOB or the Auditing Standards Board. The objective of a SSARS review is to obtain limited assurance that there are no material modifications that should be made to the financial statements in order for the statements to be in conformity with GAAP. The accountant's judgment about what is material is the same for reviews as it is for audits. Materiality is discussed in detail in Chapter 6.

The AICPA *Code of Professional Conduct* requires members to comply with the standards set forth in the SSARS. Thus, the Accounting and Review Services Committee has authority comparable to that of the Auditing Standards Board (ASB). The SSARS pronouncements apply to nonpublic companies that *do not have an annual audit*. Although this ordinarily involves annual financial statements, the standard also applies to reviews of interim financial statements of nonpublic companies that do not have an annual audit.

In a review of financial statements, the accountants perform primarily analytical procedures and inquiries to obtain sufficient appropriate **review evidence** as the basis for a conclusion on the financial statements as a whole. If the accountants become aware of a matter that causes them to believe the financial statements may be materially misstated, they design and perform additional procedures to be able to conclude on the financial statements. The conclusion provided is based on the accountants obtaining **limited assurance**, a level of assurance less than the reasonable assurance obtained in an audit but at an acceptable level for a review conclusion. The accountants' report includes a description of the nature of a review engagement to help readers of the report to be able to understand the conclusion.⁵

⁴ Chapter 20 discusses reviews performed under the AICPA *Statements on Standards for Attestation Engagements*, which ordinarily include subject matter other than historical financial statements and information.

⁵ Notice here that the word “conclusion” is used relating to reviews, whereas “opinion” is used for audits.

Screening the Client

One of the basic elements of quality management in a public accounting firm relates to the acceptance and continuance of client relationships. The purpose of policies and procedures in this area is to minimize the risk of association with a client whose management lacks integrity. One means of acquiring information about a prospective client is to contact the client's predecessor CPAs.

AICPA AR-C 90 provides guidelines for accountants who decide to make inquiries of the predecessor accountants before accepting a review (or compilation) engagement. These inquiries include questions regarding the integrity of management, disagreements over accounting principles, the willingness of management to provide or revise information, and the reasons for the change in accountants. The decision of whether to contact the predecessor accountants is left to the judgment of the successor CPAs. However, if inquiries are made with the client's consent, the predecessor accountants are generally required to respond.

As discussed in Chapter 6, the AICPA professional standards address accountant responsibilities when an audit client has requested the accountants to change the engagement from an audit to a review engagement. This may affect the accountants' decision to accept the engagement.

Engagement Letters

Reviews and compilations are quite different from audits. The need to establish a clear understanding with the client concerning the nature of such services was dramatically illustrated in the *1136 Tenants' Corporation* case discussed in Chapter 4. CPAs must avoid the implication that they are performing audits when they are engaged to perform other services. Accordingly, the professional standards require that CPAs prepare an *engagement letter* (or other suitable form of written communication) clearly specifying the objectives of the engagement, management's responsibilities, the accountant's responsibilities, and limitations of the engagement.

Understanding the Client and Its Industry

After a client has been accepted, the auditors obtain further understanding of both the client and its industry. This information is used to help design review procedures as well as to evaluate the responses to their inquiries and the results of the review procedures. The accountants' understanding of the client's business should include a general understanding of the company's organization, its methods of operation, and the nature of its financial statement accounts.

Review Procedures

As we have indicated, during a review engagement the accountants (1) perform analytical procedures, (2) make inquiries of management and others within the organization, (3) perform other procedures considered necessary, and (4) obtain representations from management relating to the financial statements.

Analytical procedures (generally comparisons of accounts and ratios) are applied to the financial data by reference to prior financial statements, budgets, and other operating data. The approach used when the accountants perform analytical procedures⁶ is to compare recorded amounts and ratios to expected amounts, identify significant differences that might indicate a misstatement, and then investigate the unexpected amounts. For example, revenue reported by month, product line, or business segment may be compared to amounts from comparable prior periods. When unexpected differences are noted, they are investigated further by making inquiries of management or performing other procedures.

The CPAs' *inquiries* should focus on whether the financial statements are in accordance with generally accepted accounting principles, changes in business activities, significant subsequent events, and knowledge of material fraud or suspected fraud.

⁶ Chapter 5 presents general guidance on analytical procedures.

Other procedures performed in a review include making inquiries concerning actions taken at stockholder and director meetings, reading the interim financial information, and obtaining reports from other accountants who have reviewed significant components of the company.

Although a review ordinarily does not require accountants to corroborate management's responses, they should perform the engagement with professional skepticism and consider the consistency of management responses in light of the results of other review procedures. Additional procedures should be performed if the accountants become aware that information may be incorrect, incomplete, or otherwise unsatisfactory. The accountants should perform these procedures to the extent considered necessary to obtain limited assurance that there are no material modifications that should be made to the statements. For example, if review procedures lead an accountant to question whether a significant sales transaction is recorded in conformity with generally accepted accounting principles, it may become necessary to discuss the terms of the transaction with both senior marketing and accounting personnel and to read the sales contract. Figure 19.2 summarizes analytical procedures, inquiries, and other review procedures.

Finally, the auditors must obtain a representation letter that is tailored to the circumstances of the particular engagement. However, all representation letters should be dated as of the date of the review report and include management's acknowledgment of its

- Responsibility for the financial statements' conformity with generally accepted accounting principles and its belief that it has met this responsibility.
- Responsibility to prevent and detect fraud, as well as to divulge any knowledge that it has of any actual or suspected fraud that is material.
- Responsibility to respond fully and truthfully to all inquiries and to provide complete information, including that on subsequent events.

Review Reports

The assurance provided by a review report is necessarily limited because of the limited scope of the accountants' procedures. Although these procedures may bring to the CPAs' attention significant departures from GAAP, they provide less assurance than does an audit. A review is not sufficient to enable the accountants to express an opinion on the fairness of the financial statements. Therefore, the first paragraph of the accountants' report concludes with a statement that the accountants do not express such an opinion.

FIGURE 19.2
Nonpublic Company
Analytical Procedures,
Inquiries, and Other
Review Procedures

Analytical Procedures • Develop <i>expectations</i> by identifying plausible relationships that are reasonably expected to exist. • Compare recorded amounts or ratios developed from recorded amounts to expectations. • Compare the consistency of management's responses in light of results of other review procedures and knowledge of business and industry. Other Review Procedures • Inquire as to actions taken at meetings of shareholders, board of directors, and other committees of board of directors. • Read financial statements. • Obtain reports from other accountants, if any, that have reviewed significant components.	Inquiries of Management Members with Responsibility for Financial and Accounting Matters about: • Whether financial statements are prepared in conformity with GAAP • The accounting principles, practices, and methods applied • Any unusual or complex situations that might affect the financial statements • Significant transactions taking place near the end of the period • Status of uncorrected misstatements identified in a previous engagement • Questions that have arisen in applying review procedures • Subsequent events • Knowledge of potentially material fraud or suspected fraud • Significant journal entries and other adjustments • Communications from regulatory agencies

The report goes on to provide a description of management and auditor responsibilities, and a conclusion indicating that the CPAs are not aware of any needed modifications (this is often referred to as limited assurance). The body of an accountants' standard report on a review of a nonpublic company's financial statements reads as follows:

Independent Accountant's Review Report

[Appropriate Addressee]

We have reviewed the accompanying financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20XX, and the related statements of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements. A review includes primarily applying analytical procedures to management's financial data and making inquiries of company management. A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, we do not express such an opinion.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement whether due to fraud or error.

Accountant's Responsibility

Our responsibility is to conduct the review engagement in accordance with Statements on Standards for Accounting and Review Services promulgated by the Accounting and Review Services Committee of the American Institute of Certified Public Accountants. Those standards require us to perform procedures to obtain limited assurance as a basis for reporting whether we are aware of any material modifications that should be made to the financial statements for them to be in accordance with accounting principles generally accepted in the United States of America. We believe that the results of our procedures provide a reasonable basis for our conclusion.

We are required to be independent of XYZ Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements related to our review.

Accountant's Conclusion

Based on our review, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

[Signature of accounting firm or accountant, as appropriate]

[Accountant's city and state]

[Date of the accountant's review report]

The date of an accountant's review report should not be earlier than the date on which the accountant has accumulated review evidence sufficient to provide a reasonable basis for providing limited assurance on the financial statements. Also, although not required, the accountant may consider marking each page of the financial statements with a caption such as "See Independent Accountants' Review Report."

To provide any degree of assurance about the fairness of information, the CPAs must be independent. Thus, professional standards require the accountants to be independent of the client.

Departures from Generally Accepted Accounting Principles

A modification of the report is required when the accountants become aware of a material departure from generally accepted accounting principles (or some other comprehensive basis of accounting). When the effects of the matters are material but not pervasive to the financial statements, a qualified conclusion is appropriate; when the effects are material and pervasive, an adverse conclusion is appropriate. The following provides illustrations of qualified and adverse conclusions:

Qualified Conclusion

Based on our review, except for the effect of the matter described in the Basis for Qualified Conclusion paragraph, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in accordance with accounting principles generally accepted in the United States of America.

Adverse Conclusion

Based on our review, due to the significance of the matters described in the Basis for Adverse Conclusion paragraph, the financial statements are not in accordance with accounting principles generally accepted in the United States of America.

In a separate paragraph of the review report, the departure will be described. The following is an example of a report section that discusses a departure from generally accepted accounting principles that would precede the Conclusion section. This section could be appropriate for a report with a qualified conclusion (material misstatement, effects not pervasive) or an adverse conclusion (material misstatement with pervasive effect).

Basis for Qualified (or Adverse) Conclusion

As disclosed in Note 6 to the financial statements, generally accepted accounting principles require that land be stated at cost. Management has informed us that the Company has stated its land at appraised value and that, if generally accepted accounting principles had been followed, the land account and stockholders' equity would have been decreased by \$500,000.

When the applicable financial reporting framework requires management to evaluate the entity's ability to continue as a going concern for a reasonable period (e.g., GAAP includes such a requirement), accountants must perform related review procedures. When the framework includes no such going concern evaluation requirement, accountants should still be aware of the possibility of substantial doubt. In either case, when substantial doubt exists, the accountants should add a separate section in the accountant's review report with the heading "Substantial Doubt about the Entity's Ability to Continue as a Going Concern" and consider the adequacy of financial statement disclosures. Inadequate disclosures will result in either a qualified or adverse conclusion.

Review reports are not required to be altered in situations involving a lack of consistent application of generally accepted accounting principles or the existence of major uncertainties other than those related to going concern. However, when that information is not properly presented or disclosed in the financial statements, the financial statements contain a departure from generally accepted accounting principles and the review report should be appropriately modified to include either a qualified or adverse conclusion. Finally, if the accountant is not able to obtain sufficient appropriate review evidence to form a conclusion, the review is considered incomplete and the accountant should withdraw from the engagement without issuing a review report.

Review Reports on Comparative Statements

As with audited financial statements, accountants who have reviewed prior-period financial statements presented with those of the current period should report on both years. If the accountants have reviewed both sets of financial statements, they will merely update their review report on the prior year by issuing one review report covering both years. The report will be dated as of the completion of the current year's review procedures.

In certain situations, the accountants may be engaged to perform a lower level of service on the current year's financial statements than they performed on the prior year's financial statements (e.g., a review this year and an audit last year or a compilation this year and a review last year). In these situations, the CPAs should not update the prior year's report. This would imply that they have performed those types of services to the



Illustrative Case

Difference between CPAs' Responsibilities



The difference between CPAs' responsibilities when performing audits and reviews of financial statements was dramatically illustrated by the ZZZZ Best case. ZZZZ Best Inc. was a company engaged in the business of carpet cleaning and restoring fire- and flood-damaged buildings. The company, which was founded by 16-year-old Barry Minkow, reported operating results that were almost wholly fictitious.

In the review of the financial statements of ZZZZ Best, the partner-in-charge of the engagement insisted upon observing

two major restoration jobs, a finished job, and a carpet warehouse. However, Minkow and other officers of the company cleverly faked these locations. As a result, the observations did not result in detection of the fraud, and the public accounting firm also agreed not to make follow-up contacts with the insurance companies and building owners involved. The court ruled that the accounting firm was not liable for failing to detect the misstatements of the financial statements. The court noted that the accountants' review report specifically disclaimed an opinion on ZZZZ Best's financial statements.

date of the current year's report. Instead, the CPAs should either reissue the prior year's report bearing its original date and present it with the current year's report or include a reference to the prior year's report in the current year's report. For example, the following paragraph could be added to a compilation report on the current year's financial statements to refer to a review of the comparative financial statements for the prior year.

The accompanying 20X1 financial statements of XYZ Company were previously reviewed by us, and our report dated March 1, 20X2, stated that we were not aware of any material modifications that should be made to those statements in order for them to be in conformity with generally accepted accounting principles. We have not performed any procedures in connection with that review engagement after the date of our report on the 20X1 financial statements.

A reference similar to the one above also should be included in the current report when another public accounting firm, whose report is not presented, reviewed the comparative financial statements.

Other Communications

As with annual financial statement audits, the CPAs should communicate to the audit committee the information about significant adjustments found during the review and the acceptability and quality of significant accounting policies and estimates. The audit committee also should be informed about any disagreements with management over accounting principles or review procedures, or any other difficulties encountered in performing the review. These communication responsibilities with respect to an audit were described in detail in Chapter 16. Finally, the CPAs should make sure that the audit committee is informed about any instances of fraud or illegal acts that come to their attention, as well as any significant deficiencies and material weaknesses related to the preparation of financial statements.

PCAOB and Auditing Standards Board Reviews of Interim Information

Public companies (issuers) are required to have annual audits and *interim reviews* of the first three quarters of the year prior to public release of that information. The guidance for public companies' interim reviews is included in PCAOB AS 4105. **Nonpublic companies** that have their annual financial statements audited also may choose to undergo interim reviews in accordance with Auditing Standards Board (ASB) standards (AICPA AU-C 930). Interim reviews under standards of the PCAOB and the ASB are both very similar to reviews performed under the *SSARS*.

As is the case with a *SSARS* review, a starting point for a PCAOB or ASB interim review is to establish an understanding with the client regarding the nature of the engagement. The understanding, which preferably should be in writing, includes information on management's responsibilities, the accountants' responsibilities, and the nature of

LO 19-8

Discuss how reviews performed under *Statements on Standards for Accounting and Review Services* differ from those performed under the *Statements on Auditing Standards*.

reviews. An engagement letter is often used to document the understanding. A review includes obtaining an understanding of the client's business and internal control, performing review procedures, and communicating results.

Because PCAOB and ASB interim reviews are very similar in scope to those of SSARS reviews, we will not go through these engagements in detail. We simply highlight the following major differences:

- PCAOB and ASB reviews are conducted on interim information of public and nonpublic companies that have had annual audits, while SSARS reviews are conducted on nonpublic companies that have not had an annual audit. Public companies must undergo interim reviews; it is an option for nonpublic companies.
- The most significant procedural difference between a SSARS and an ASB or PCAOB interim review is that the latter two require that the accountant obtain a more detailed understanding of the company's business and particularly its internal control. The understanding that is necessary for an ASB or PCAOB interim review is one that allows the accountants to identify types of potential material misstatements and their likelihood of occurrence. This understanding allows them to select appropriate procedures that serve as the basis for the review.
- Under PCAOB standards, the accountants ordinarily are not required to issue a review report on interim financial statements.⁷ The decision on report issuance is made by the accountant and the client.

We present the PCAOB report here (the ASB report is included in AU-C 930):

Report of Independent Registered Public Accounting Firm

To the Shareholders and the Board of Directors of ABC Company

Results of Review of Interim Financial Statements

We have reviewed the accompanying balance sheet and related statements of income, retained earnings and cash flows of ABC Company (the "Company") and consolidated subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods then ended, and the related notes (collectively referred to as the "interim financial statements"). Based on our review, we are not aware of any material modifications that should be made to the accompanying interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

Basis for Review Results

These interim financial statements are the responsibility of the Company's management. We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the PCAOB, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Warren & Warren LLP
Houston, TX
October 12, 20X1

Compilation and Preparation of Historical Financial Statements

LO 19-9

Explain the accountant's responsibilities when compiling and preparing financial statements.

The public accounting profession has developed financial statement compilation and preparation services to respond to clients that request financial statement assistance. Because neither compilation nor preparation results in accountants providing assurance on the financial statements, accountants performing such services need not be independent of their client. The following two sections describe these two services: compilation and preparation of financial statements.

⁷ An exception is if a document containing the reviewed interim financial information makes reference to the accountant's review—in such a situation, a review report must be issued.

Compilation of Financial Statements

A compilation involves assisting management in presenting financial information in the form of financial statements. To perform a compilation, *SSARS* require the accountants to have knowledge of the accounting principles and practices used within the client's industry and a general understanding of the client's business transactions and accounting records. The accountants should evaluate the client's representations in light of this knowledge.

At a minimum, the accountants should read the compiled statements for appropriate format and to identify obvious material misstatements. When performing a compilation, the accountants must not accept patently unreasonable information. If the client's information appears to be incorrect, incomplete, or otherwise unsatisfactory, the accountants should insist upon revised information. If the client refuses to provide revised information, the accountants should withdraw from the engagement. Beyond these basic requirements, accountants have no responsibility to perform any investigative procedures to substantiate the client's representations.

In a compilation report, the accountants provide no assurance on the financial statements. The following is a standard report:

Management is responsible for the accompanying financial statements of XYZ Company, which comprise the balance sheet as of December 31, 20X2, and the related statements of income, changes in stockholder's equity, and cash flows for the years then ended, and the related notes to the financial statements in accordance with accounting principles generally accepted in the United States of America. We have performed a compilation engagement in accordance with *Statements on Standards for Accounting and Review Services* promulgated by the Accounting and Review Services Committee of the AICPA. We did not audit or review the financial statements nor were we required to perform any procedures to verify the accuracy or completeness of the information provided by management. Accordingly, we do not express an opinion or a conclusion, or provide any form of assurance on these financial statements.

Signature [accountant or accountant's firm]

City and state where accountant practices

Date [date accountant completed required procedures]

Although not required, each page of the unaudited financial statements may be marked "See Accountants' Compilation Report" or "See Accountant's Report." The accountants' report should be dated as of the completion of compilation procedures.

Accountants may issue a compilation report on one or more individual financial statements, without compiling a complete set of statements. Also, financial statements may be compiled on a framework of accounting *other than* generally accepted accounting principles. In this case, the basis of accounting used must be disclosed either in the statements or in the accountants' report.

Departures from Generally Accepted Accounting Principles

Treatment of departures from generally accepted accounting principles parallels that for reviews of financial statements. A departure from generally accepted accounting principles requires the accountants to discuss the departure in a separate paragraph in the compilation report. If the accountant believes that modification of the standard report is not adequate to indicate the deficiencies in the financial statements, the accountant should withdraw from the engagement. As is the situation with review reports, compilation reports are not required to be altered in situations involving a lack of consistent application of generally accepted accounting principles or the existence of major uncertainties (including going-concern uncertainties) that have been properly reported in the financial statements. When that information is not properly reported in the financial statements, the accountants should modify the compilation report for a departure from generally accepted accounting principles.

Compilations That Omit Substantially All Disclosures

The numerous disclosures required by generally accepted accounting principles may not be particularly useful in the financial statements of a nonpublic business, especially when the statements are intended for internal use by management. Therefore, a nonpublic client

may request CPAs to compile financial statements that omit substantially all of the disclosures required by GAAP. CPAs may compile such statements, provided that the omission is not undertaken to mislead financial statement users and is clearly indicated in the accountants' report. In such situations, the accountants should add the following last paragraph to their report:

Management has elected to omit substantially all of the disclosures required by generally accepted accounting principles. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the company's financial position, results of operations, and cash flows. Accordingly, these financial statements are not designed for those who are not informed about such matters.

If the client wishes to include only some of the disclosures required by GAAP, these disclosures may be labeled "Selected Information—Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included."

Compilations of Information in Prescribed Forms

Prescribed forms refer to standard preprinted forms designed or adopted by the institution or agency to which the form is to be submitted. A common example is a bank loan application form. Because these prescribed forms often require financial statement items to be presented on a basis other than generally accepted accounting principles, accountants compiling the forms indicate that the financial statements are presented in accordance with the requirements of the institution or regulatory body rather than GAAP. The accountants should modify the report to point out material departures from the requirements of the prescribed form.

Compilations When the CPAs Are Not Independent

CPAs may perform compilations even when they are not independent of the client. However, they should indicate their lack of independence by adding the following last paragraph to their compilation report:

We are not independent with respect to XYZ Company.

The CPAs also may provide reason(s) for the lack of independence (e.g., a member of the audit team had a direct financial interest in XYZ Company).

Preparation of Financial Statements

Accountants may be engaged to prepare financial statements (or a single financial statement) but not perform an audit, review, or compilation of those financial statements.⁸ Preparation of financial statements involves a CPA preparing (assembling) financial statements from client records. The service is considered a nonattest service and it ordinarily does not result in issuance of an accountant's report. When preparing financial statements, the accountants need not be independent of the client; in fact, they need not even determine whether they are independent.⁹

⁸ AICPA AR-C 70 presents the requirements for financial statement preparation. That section is not applicable to a number of financial statement–related services such as maintaining schedules (e.g., depreciation), preparing certain adjusting entries, entering general ledger transactions, processing payments in an accounting software system, or drafting financial statement notes. Also, its requirements do not apply when financial statements are prepared for

- Submission to a taxing authority.
- Inclusion in written personal financial plans.
- Litigation services, involving pending or potential legal or regulatory proceedings.
- Business valuation services.

⁹ This requirement differs from compilations in which a determination of independence must be made and a lack of independence must be communicated in their compilation report.

When preparing a client's financial statements, a written engagement letter (or other suitable form of written agreement) is required; the letter should be signed by both the accountant (or the accountant's firm) and management. Alternatively, in certain circumstances it may be appropriate for other parties (e.g., those charged with governance) to sign the letter instead of or in addition to management.

Accountants prepare the financial statements using the client's records, documents, explanations, and other information provided by management. To perform the engagement, the accountants should have or obtain an understanding of the financial framework adopted by management for preparation of the financial statements (e.g., generally accepted accounting principles) and the significant accounting policies adopted by management.

Each page of the financial statements should include a statement such as (1) "No assurance is provided on these financial statements" or (2) "These financial statements have not been audited or reviewed, and no assurance is provided on them."¹⁰ If the accountant is unable to include such a statement on each page of the financial statements, the accountant should either withdraw from the engagement or issue a disclaimer that makes clear that no assurance is provided, such as

The accompanying financial statements of XYZ Company as of and for the year ended December 31, 20X3, were not subjected to an audit, review, or compilation engagement by us and, accordingly, we do not express an opinion or a conclusion, or provide any assurance on them.

If the accountants become aware that the information used in the preparation of the financial statements is materially incomplete or inaccurate, they should bring the matter to the attention of management and request additional or corrected information. While this will ordinarily solve the problem, if management does not provide such corrected information, the accountant should either (1) disclose the material misstatement on the face of the financial statements or in a financial statement note or (2) withdraw from the engagement.

As is the situation with compiled financial statements, in some circumstances a client may wish to issue financial statements that omit many of the disclosures required by generally accepted accounting principles (or other basis of accounting being followed). In such a situation, the following may be added by the disclosures that are included: "Selected Information—Substantially All Disclosures Required by Generally Accepted Accounting Principles Are Not Included." Figure 19.3 provides a comparison of financial statement preparation and compilation.

FIGURE 19.3 Comparison of Financial Statement Preparation and Compilation

Issue	Preparation	Compilation
Source of standards?	AICPA AR-C 70	AICPA AR-C 80
What is basic service being provided?	Prepare financial statements.	Prepare financial statements.
Is the accountant required to determine if he or she is independent of the client?	No	Yes
If the accountant is not independent, is that fact required to be disclosed in the accountant's report?	Not applicable	Yes
Engagement letter (or equivalent) signed by management and accountant required?	Yes	Yes
Does the engagement require an accountant's report?	No*	Yes
May the financial statements omit notes?	Yes	Yes
Departures from GAAP (or other criteria)?	Withdraw from engagement.	Modify compilation report; if modification is inadequate, withdraw from engagement.

* When an accountant is engaged to prepare financial statements, the accountant is required to include an adequate statement on each page of the financial statements indicating that the CPA provides no assurance on the financial statements. If the accountant is unable to include an adequate statement on each page of the financial statements, the accountant is required to issue a disclaimer on the financial statements.

¹⁰ AICPA, *Preparation of Financial Statements*, AR-C 70.

Chapter Summary

This chapter described CPA services on historical financial information other than audits of corporation financial statements in accordance with U.S. generally accepted accounting principles. To summarize:

1. Auditors sometimes are asked to provide additional assurance services after having conducted an audit. Regulatory requirements and debt agreements often require companies to provide compliance reports prepared by their auditors, including limited assurance about whether the company has complied with the particular requirements. In letters for underwriters (comfort letters), the auditors provide negative assurance about various information contained in registration statements used for the sale of securities. Also, clients may issue summary financial statements developed from audited financial statements, and CPAs may attest as to whether they are consistent, in all material respects, with the audited financial statements.
2. The professional standards define *special-purpose financial reporting frameworks* as (a) cash basis, (b) tax basis, (c) regulatory basis, (d) contractual basis, and (e) other. CPAs may audit financial statements following these bases and issue an audit report that alerts users to the basis being followed. Audit reports on financial statements that follow a regulatory or contractual basis also include an Other-Matter section that restricts the use, ordinarily to those in the company, the parties to the contract or agreement, or regulatory agencies.
3. The nature of auditors' reporting responsibilities on financial statements prepared using a financial framework generally accepted in another country depends upon whether there will be use of those financial statements in the United States. When the intended use is only outside the United States, the auditors may issue a U.S. form of report modified as appropriate, or the standard report of the other country. When use is also intended in the United States, a second report is issued using a U.S. form, with alterations that depend upon whether a nonpublic or public company is involved.
4. The Employee Retirement Income Security Act of 1974 (ERISA) requires covered employee benefit plans to submit audited plan financial statements with their Form 5500 filed annually with the U.S. Department of Labor. These financial statements are prepared following generally accepted accounting principles, with audits performed following AICPA generally accepted auditing standards. Two basic forms of audits exist. In the first, the overall financial statements are audited and reported upon by the auditors. In the second, the audit is similar except that auditors do not provide assurance on the investments. They rely on the certification of the plan's investments by the qualified institution (e.g., bank, insurance carrier, or similar institution) that serves as the trustee or custodian of the plan's investment assets. The audit report only indicates whether the investment information in the financial statements agrees to or is derived from the certified investment information provided by the qualified institution.
5. CPAs may audit or review single financial statements or specified elements, accounts, or items of a financial statement. They may also be engaged to perform agreed-upon procedures on single financial statements, or specified elements, accounts, or items of a financial statement. The report describes the procedures performed and findings without providing specific assurance on the subject matter of the report.
6. There are several major differences between personal financial statements and those of other types of organizations. For example, assets and liabilities on personal financial statements are presented at their estimated current values and amounts. Accountants may audit, review, or compile personal financial statements.
7. Nonpublic companies that do not have annual audits may engage CPAs to review their annual or interim financial statements under *Statements on Standards for*

Accounting and Review Services (SSARS). In a *SSARS* review, accountants primarily perform analytical procedures and inquiries to obtain sufficient appropriate review evidence as the basis for a conclusion on the financial statements as a whole. If the accountants become aware of a matter that causes them to believe the financial statements may be materially misstated, they design and perform additional procedures so as to be able to conclude on the financial statements. The conclusion provided is based on the accountant obtaining limited assurance. The accountants' report includes a description of the nature of a review engagement to allow readers of the report to be able to understand the level of assurance provided. If the accountants conclude that the financial statements are materially misstated, they should issue a qualified or adverse conclusion.

8. Public companies must engage CPAs to review the company's interim financial statements while nonpublic companies that have annual audits may choose to do so; these reviews are under ASB or PCAOB standards. These interim reviews are similar in nature to those performed under *SSARS*. However, under ASB and PCAOB standards, the auditors must obtain an understanding of client internal control.
9. In financial statement compilation and preparation engagements, accountants provide no assurance with respect to the financial statements. Neither form of association requires accountant independence. A compilation results in an accountant's report with no assurance. Financial statement preparation ordinarily results in no accountant's report, unless the financial statements do not make clear that accountants are providing no assurance.

Key Terms Introduced or Emphasized in Chapter 19

Agreed-upon procedures (870) An attestation engagement in which a practitioner performs specific procedures on subject matter and reports the findings without providing an opinion or a conclusion on it.

Comfort letter (862) A letter issued by the independent auditors to the underwriters of securities registered with the SEC under the Securities Act of 1933. Comfort letters deal with such matters as the auditors' independence and the compliance of unaudited data with requirements of the SEC.

Compilation (873) An accounting service with the objective of assisting management in presenting financial information in the form of financial statements without obtaining or providing any assurance on those statements.

Employee Retirement Income Security Act of 1974 (ERISA) (866) A federal law that sets minimum standards for most voluntarily established retirement and health plans in private industry designed to provide protection for individuals in these plans.

Engaging party (870) The party(ies) that hires the practitioner to perform the engagement.

Financial reporting framework (863) A set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements. Financial reporting frameworks may be general-purpose financial reporting frameworks or special-purpose financial reporting frameworks.

General-purpose financial reporting frameworks (863) Financial reporting frameworks designed to meet the common financial information needs of a wide range of users. Examples of general-purpose financial reporting frameworks are accounting principles generally accepted in the United States of America and *International Financial Reporting Standards* issued by the International Accounting Standards Board.

Limited assurance (873) A level of assurance that is less than the reasonable assurance obtained in an audit but is at an acceptable level as the basis for the conclusion expressed in the accountant's review report. Limited assurance is also referred to as negative assurance.

Negative assurance (862) A statement that in essence indicates that based on the procedures performed, nothing came to the auditor's attention that caused the auditor to believe that the information did not meet the criteria. For example, in the context of reviewed nonpublic company financial

statements, “we are unaware of any material modifications that should be made. . . .” The term has been largely replaced in the auditing standards by the term *limited assurance*, although it still exists in certain auditing standards (e.g., letters for underwriters, included in Chapter 19).

Nonissuer (873) A company whose securities are *not* registered under requirements of the Securities and Exchange Commission; ordinarily, a “nonissuer” is a nonpublic company. This is in contrast to an issuer, a company whose securities are registered under the requirements of the Securities and Exchange Commission.

Nonpublic company (878) A company other than one whose securities are traded on a public market or one that makes a filing with a regulatory agency in preparation for the sale of securities on a public market.

Preparation of financial statements (873) An accounting service that involves a CPA preparing (assembling) financial statements from client records. No assurance is provided and, ordinarily, no accountant’s report is issued.

Public company (issuer) (878) A company whose stock is traded on a public market or a company in the process of registering its stock for public sale.

Qualified institution (867) Under Department of Labor (DOL) regulations, a qualified institution is one that is regulated and subject to periodic examination by a state or federal agency such as a bank, trust company, or similar institution including an insurance company.

Review evidence (873) Information used by the accountant to provide a reasonable basis for obtaining limited assurance. Review evidence includes both information contained in the accounting records underlying the financial statements and other information, which primarily consists of the results of analytical procedures and inquiries.

Review of financial statements (873) A form of attestation based on inquiry and analytical procedures applied for the purpose of expressing limited assurance that historical financial statements are presented in accordance with generally accepted accounting principles or some other appropriate basis.

Special-purpose financial reporting frameworks (863) Financial reporting frameworks other than GAAP that are one of the following bases of accounting:

- **Cash basis.** A basis of accounting that the entity uses to record cash receipts and disbursements and modification of the cash basis having substantial support (e.g., recording depreciation on fixed assets).
- **Tax basis.** A basis of accounting that the entity uses to file its tax return for the period covered by the financial statements.
- **Regulatory basis.** A basis of accounting that the entity uses to comply with the requirements or financial reporting provisions of a regulatory agency to whose jurisdiction the entity is subject. An example is a basis of accounting that insurance companies use pursuant to the rules of a state insurance commission.
- **Contractual basis.** A basis of accounting that the entity uses to comply with an agreement between the entity and one or more third parties other than the accountant.
- **Other basis.** A basis of accounting that uses a definite set of logical, reasonable criteria that is applied to all material items appearing in financial statements. Special-purpose frameworks (not including contractual basis) are commonly referred to as other comprehensive bases of accounting.

Summary financial statements (condensed financial statements) (862) Historical financial information that is derived from the financial statements but contains less detail, while still providing a structured representation consistent with the financial statements.

Review Questions

- 19–1. Evaluate this statement: “All companies should be audited annually.”
- 19–2. Evaluate this statement: “Auditors perform attestation services and accountants perform accounting services.”
- 19–3. In communications with clients, should CPAs refer to themselves as auditors or as accountants? Explain.
- 19–4. Can auditors express an unmodified opinion on financial statements that are not presented on the basis of generally accepted accounting principles? Explain.
- 19–5. Provide four types of special-purpose financial reporting frameworks.

- 19-6. Comment on the following: "Because of the nature of the frameworks the clients use, audits of *special-purpose* financial reporting frameworks result in an audit report that is restricted for use by those within the entity."
- 19-7. A client has prepared financial statements using a financial reporting framework generally accepted in another country. The statements are intended only to be used in that country. Describe the auditor's reporting options.
- 19-8. Jane Wilson has prepared personal financial statements in which her assets are valued at her historical cost, less appropriate depreciation. Is this presentation in conformity with generally accepted accounting principles? Can a public accounting firm audit these statements and issue a report with an unmodified opinion?
- 19-9. What are the general types of procedures performed during a review of the quarterly financial statements of a company that has audits of its annual financial statement?
- 19-10. Describe a unique reporting aspect about the CPAs' required review of the quarterly financial statements of public companies.
- 19-11. How do CPAs of public companies assist audit committees in performing their oversight function with respect to quarterly financial statements?
- 19-12. What types of services may be performed by CPAs with respect to the financial statements of nonpublic companies?
- 19-13. How does a review of the financial statements of a nonpublic company differ from an audit?
- 19-14. What are the types of procedures performed during the review of the financial statements of a nonpublic company?
- 19-15. Are engagement letters needed for accounting and review services? Explain.
- 19-16. What is the purpose of a comfort letter? Discuss.
- 19-17. What form of opinion will the auditors normally issue with respect to *summary financial statements* that the client has developed from the audited financial statements?
- 19-18. What procedures are required when a CPA performs a compilation of financial statements?
- 19-19. Can the CPAs report on a nonpublic client's financial statements that omit substantially all disclosures required by generally accepted accounting principles? Explain.
- 19-20. What should the accountants do if they discover that the financial statements they are compiling contain a material departure from generally accepted accounting principles?
- 19-21. When a CPA has prepared a client's financial statements, how is the fact that no assurance is provided indicated?
- 19-22. Assume that a public accounting firm is reviewing the financial statements of a nonpublic company and discovers that the firm is not independent. What options are available to the firm?

Questions Requiring Analysis

LO 19-7, 9

Select questions are available with Connect.



- 19-23. You have been asked by Ambassador Hardware Co., a small nonpublic company, to submit a proposal for the audit of the company. After performing an investigation of the company, including its management and accounting system, you advise the president of Ambassador that the audit fee will be approximately \$20,000. Ambassador's president was somewhat surprised at the fee, and after discussions with members of the board of directors, he concluded that the company could not afford an audit at this time.
 - a. Discuss management's alternatives to having their company's financial statements audited in accordance with generally accepted auditing standards.
 - b. What should Ambassador's management consider when selecting the type of service that you should provide? Explain.
- LO 19-2 19-24. Schmich and Schmich, CPAs, in Minneapolis, Minnesota, has completed the audit of XYM Co. for the year ended December 31, 20X1. The financial statements for this nonpublic client are prepared following the cash basis of accounting. Note 7 to the financial statements refers to an uncertainty due to material litigation against XYM related to an employee's charges of age discrimination that the employee believes result in his inability to secure a promotion. Schmich and Schmich has determined that an unmodified opinion is appropriate, although the uncertainty should be referred to in the audit report. Draft the audit report Opinion and Emphasis-of-Matter sections for (1) the basis of accounting and (2) the uncertainty.

- LO 19-5** 19–25. Occasionally, public accounting firms are engaged to report on specified elements, accounts, and items of financial statements. Discuss types of reports that may be provided for a nonpublic company for specified elements, accounts, and items of financial statements.
- LO 19-7** 19–26. You have been engaged by the management of Pippin Inc., a nonpublic company, to review the company's financial statements for the year ended December 31, 20XX. To prepare for the engagement, you consult the *Statements on Standards for Accounting and Review Services*.
- Discuss the procedures required for the performance of a review of financial statements.
 - Explain the content of the report on a review of financial statements.
 - Discuss your responsibilities if you find that the financial statements contain a material departure from generally accepted accounting principles.
- LO 19-1** 19–27. In connection with a public offering of first-mortgage bonds by Guizzetti Corporation, the bond underwriter has asked Guizzetti's CPAs to furnish it with a comfort letter giving as much assurance as possible on Guizzetti's unaudited financial statements for the three months ended March 31. The CPAs had expressed an unqualified opinion on Guizzetti's financial statements for the year ended December 31, the preceding year; they also performed a review of Guizzetti's financial statements for the three months ended March 31. Nothing has come to their attention that would indicate that the March 31 statements are not properly presented.
- Explain what can be stated about the unaudited financial statements in the letter.
 - Discuss other matters that are typically included in comfort letters.
- LO 19-9** 19–28. Andrew Wilson, CPA, has assembled the financial statements of Texas Mirror Co., a small nonpublic company. He has not performed an audit of the financial statements in accordance with generally accepted auditing standards. Wilson is confused about the standards applicable to this type of engagement.
- Explain where Wilson should look for guidance concerning this engagement.
 - Explain Wilson's responsibilities with respect to a preparation of these financial statements.

Objective Questions

- LO 19-7** 19–29. **Multiple Choice Questions**
Select the best answer for each of the following and explain fully the reason for your selection.
- Which of the following is *not* typically performed when the auditors are performing a review of client financial statements?
 - Analytical procedures applied to financial data.
 - Inquiries about significant subsequent events.
 - Confirmation of accounts receivable.
 - Obtaining an understanding of accounting principles followed in the client's industry.
 - Which of the following must be obtained in a review of a nonpublic company?

LO 19-7

	Engagement Letter	Representation Letter
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

LO 19-7, 9

- A CPA who is *not* independent may perform which of the following services for a nonpublic company?

	Compilation	Review
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

LO 19-7

d. When performing a review of a nonpublic company, which is *least* likely to be included in auditor inquiries of management members with responsibility for financial and accounting matters?

- (1) Subsequent events.
- (2) Significant journal entries and other adjustments.
- (3) Communications with related parties.
- (4) Unusual or complex situations affecting the financial statements.

LO 19-5

e. The proper report by an auditor relating to summarized financial statements includes:

- (1) A statement about the type of opinion expressed in the prior year.
- (2) An adverse opinion.
- (3) An opinion on whether the summarized information is fairly stated in all material respects in relation to the basic financial statements.
- (4) No assurance on the information.

LO 19-8

f. Concerning interim quarterly financial statements, management of public companies:

- (1) Must engage CPAs to audit the statements.
- (2) Must engage CPAs to review the statements.
- (3) May choose to engage CPAs to review the statements.
- (4) May not engage CPAs to become associated with the statements.

LO 19-9

g. A proper compilation report on financial statements that omit note disclosures:

- (1) Includes an adverse opinion.
- (2) Includes a disclaimer of opinion on the accuracy of such note disclosures.
- (3) Indicates that management has omitted such information.
- (4) Indicates that note disclosures are not necessary for those not informed about such matters.

LO 19-1, 7, 9

h. Which of the following forms of accountant association is **least** likely to result in issuance of an accountant's report on financial statements or financial information?

- (1) Compilation.
- (2) Review.
- (3) Preparation.
- (4) Agreed-upon procedures.

LO 19-6

i. Which assertion is generally most difficult to attest to with respect to personal financial statements?

- (1) Existence and occurrence.
- (2) Rights and obligations.
- (3) Completeness.
- (4) Valuation.

LO 19-2

j. Financial statements prepared following which of the following are most likely to be considered a special-purpose financial reporting framework?

- (1) Generally accepted accounting principles.
- (2) *International Financial Reporting Standards*.
- (3) Financial reporting standards of a foreign nation.
- (4) The cash basis of accounting.

LO 19-7, 9

k. In which of the following reports should a CPA *not* express limited assurance?

- (1) A standard compilation report on financial statements of a nonpublic entity.
- (2) A standard review report on interim financial statements of a public entity.
- (3) A standard review report on financial statements of a nonpublic entity.
- (4) A comfort letter on financial information included in a registration statement filed with the Securities and Exchange Commission.

LO 19-1

l. Comfort letters to underwriters are normally signed by the:

- (1) Independent auditor.
- (2) Underwriter.
- (3) Client's lawyer.
- (4) Chief executive officer.

- LO 19-2** 19–30. The following statements relate to auditor reporting on financial statements prepared using special-purpose financial reporting frameworks. For each, indicate whether the statement is correct or incorrect.

Statement	Correct	Incorrect
1. A special-purpose financial reporting framework is any framework other than GAAP.		
2. Some, but not all, special-purpose frameworks require an indication that the financial statements are intended solely for certain specified users.		
3. An audit report on financial statements that are prepared using a special-purpose framework must include an emphasis-of-matter paragraph alerting users that the financial statements were prepared in accordance with the framework.		
4. An audit report on financial statements that are prepared using a special-purpose framework must include, in all circumstances, a description of the purposes for which the statements are prepared.		
5. An audit opinion on financial statements that use a special-purpose framework may be unmodified.		
6. The <i>Attestation Standards</i> , not the <i>Statements on Auditing Standards</i> , apply to engagements involving special-purpose frameworks.		
7. If a regulatory agency requires a particular layout for the audit report, the auditor may be able to use that layout rather than the suggested report included in the <i>Professional Standards</i> .		
8. An audit report on financial statements that are prepared using a special-purpose framework will indicate that the audit was conducted in accordance with the special-purpose financial reporting framework auditing standards.		

- LO 19-3** 19–31. Bill Jones, the president of AMTO, a nonpublic audit client of your firm, has come to you and indicated that his company established a subsidiary in the country of Laos this year and that he wants your firm to issue an audit report on that subsidiary for use in Laos for various purposes. The financial statements should follow Laotian generally accepted accounting principles. Answer the following questions relating to this situation.

Question	Yes	No
1. Is this considered an audit of financial statements using a special-purpose financial reporting framework?		
2. In performing the audit, must your firm consider GAAS to the extent the standards are appropriate?		
3. If the financial statements are intended for use only outside the United States, must an audit report include an opinion on whether U.S. GAAP are followed?		
4. If the resulting audit report will be used extensively both in the United States and in Laos, must the report include an opinion on whether U.S. GAAP are followed?		
5. If Laotian generally accepted auditing standards do not require the Laotian form of audit report, may your firm use the U.S. report form and modify it as necessary?		
6. If Laotian generally accepted auditing standards do not require the Laotian form of audit report, may your firm use the Laotian report form?		
7. Must a paragraph be added to the report indicating that the financial statements are intended solely for certain specified users?		

- LO 19-2** 19–32. State whether you agree or disagree with each of the following relating to the topic of special-purpose financial reporting frameworks.
- International Financial Reporting Standards* are considered a special-purpose financial reporting framework.
 - Cash-basis financial statements are considered as having been prepared following a special-purpose financial reporting framework, and their use should be restricted to specified users.

- c. Financial statements prepared following a contractual basis are considered as having been prepared following a special-purpose financial reporting framework, and their use should be restricted to specified users.
- d. An emphasis-of-matter paragraph should be added to a cash-basis set of financial statements indicating that the framework is other than GAAP.
- e. When financial statements are prepared following a contractual basis, the auditors must obtain an understanding of significant management interpretations of the contract.

19–33. **Multiple Choice Questions on Employee Benefit Plan Audits**

- a. ERISA audits of financial statements of employee benefit plans are performed using:
 - (1) Department of State auditing standards.
 - (2) ERISA generally accepted auditing standards.
 - (3) Generally accepted auditing standards.
 - (4) Government auditing standards.
- b. A primary difference in ERISA employee benefit plan audits performed under ERISA Section 103(a)(3)(C) and other ERISA employee benefit plan audits relates to:
 - (1) Audit coverage of plan investment assets.
 - (2) Auditor independence requirements.
 - (3) Filing deadlines.
 - (4) The financial statements audited.
- c. Which of the following types of benefit plans generally have ERISA audits?

	Health Benefits	Restitution Benefits
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

- d. Employee benefit plans subject to ERISA are ordinarily included in which Department of Labor form?
 - (1) 1A.
 - (2) 1040.
 - (3) 5500.
 - (4) 7200-12-3.
- e. The first section of an ERISA Section 103(a)(3)(C) audit is:
 - (1) Basis for Opinion
 - (2) Opinion
 - (3) Other Matter Section
 - (4) Scope and Nature

LO 19-2, 5, 9

19–34. **Simulation**

Indicate whether a CPA may provide each of the following services, and whether independence is required, by placing a check in the appropriate box.

Service	May Provide; Independence Is Required	May Provide; Independence Is Not Required	May Not Provide
a. Provide an opinion on whether financial statements are prepared following the cash basis of accounting.			
b. Compile the financial statements for the past year and issue a publicly available report.			
c. Apply certain agreed-upon procedures to accounts receivable for purposes of obtaining a loan, and express a summary of findings relating to those procedures.			

Service	May Provide; Independence Is Required	May Provide; Independence Is Not Required	May Not Provide
d. Review quarterly information and issue a report that includes limited assurance.			
e. Perform an audit of the financial statements on whether they are prepared following generally accepted accounting principles.			
f. Prepare the financial statements for the past year.			

LO 19-1, 5, 7, 8, 9 19–35. **Simulation**

Auditors who audit public and nonpublic companies must be familiar with professional standards developed by a variety of sources. For each of the types of services below, indicate the proper source of professional requirements. Each source may be used once, more than once, or not at all.

Service	Source of Standards
a. An annual review of the financial statements of a nonpublic company. b. A quarterly review of the financial statements of a nonpublic company that has an annual audit. c. A quarterly review of the financial statements of a public company that has an annual audit. d. An audit of the financial statements of a nonpublic company. e. A compilation of the financial statements of a nonpublic company. f. A quarterly review of the financial statements of a nonpublic company that annually has a review of its financial statements. (Note: The question is on the quarterly review.) g. A letter to an underwriter of a public company. h. A report on summary financial statements of a nonpublic company. i. An audit of a public company.	1. Accounting and Review Services Committee <i>Statements on Standards for Accounting and Review Services</i> 2. Auditing Standards Board <i>Statements on Auditing Standards</i> 3. PCAOB <i>Auditing Standards</i>

Problems **LO 19-2** 19–36. Jiffy Clerical Services is a company that furnishes temporary office help to its customers. The company maintains its accounting records on a basis of cash receipts and cash disbursements. You have audited the company for the year ended December 31, 20X4, and have concluded that the company's financial statements represent a fair presentation on that basis.

- Draft the section that includes the opinion of the unmodified auditors' report you would issue covering the financial statements (a statement of assets and liabilities and the related statement of revenue collected and expenses paid) for the year ended December 31, 20X4.
- Briefly discuss and justify your modifications of the conventional opinion in the standard auditors' report on GAAP financial statements.

LO 19-7 19–37. Loman, CPA, who has audited the financial statements of the Broadwall Corporation, a publicly held company, for the year ended December 31, 20X6, was asked to perform a review of the financial statements of Broadwall Corporation for the period ending March 31, 20X7. The engagement letter stated that a review does not provide a basis for the expression of an opinion.

- Explain why Loman's review will *not* provide a basis for the expression of an opinion.
- What are the review procedures Loman should perform, and what is the purpose of each procedure? Structure your response as follows:

Procedure	Purpose of Procedure

(AICPA, adapted)

In-Class Team Case

LO 19-2, 5, 7, 9

19–38. Webstar, a nonpublic company, is owned by Ben Williams and three of his friends. Previously, the company's financing has been internally generated, with limited equity contributions by the owners. The company has not been audited in the past, and Williams has said to you that while he generally understands the nature of an audit, he would like to discuss services other than an audit. Specifically, he read a brief article in a management journal that described reviews, compilations, financial statements prepared following another comprehensive basis of accounting (other than generally accepted accounting principles), and auditing specified elements of financial statements. Among his questions are the following:

a. Review of financial statements:

- (1) Is the review form of association available for Webstar's financial statements?
- (2) What procedures are typically included in a review?
- (3) What type of assurance is included in a review report?
- (4) What will result in modification of a review report?
- (5) Williams says that he heard something about there being a requirement that every company obtain a review of its financial statements. He has been concerned because he never has had this done. What's the story with this?

b. Compilation of financial statements:

- (1) Is the compilation form of association available?
- (2) What procedures are typically included in a compilation?
- (3) If a compilation is performed, must a compilation report be issued?
- (4) What type of assurance would be provided in a compilation report?
- (5) What will result in modification of a compilation report?

c. Financial statements: Williams says he isn't sure he wants to prepare financial statements following GAAP. He says he needs only statements based on the income tax method he uses to file his income taxes.

- (1) Are you able to issue an audit report based on the income tax basis?
- (2) What type of report is this?
- (3) How will the report issued differ from that of a GAAP audit?

d. Auditing a small portion of financial statements: Williams has given some thought to having an audit of just his company's revenues for the year and receivables at year-end.

- (1) May you perform an audit of only these two accounts?
- (2) What types of engagements are possible here?
- (3) What type of assurance will be provided in these reports?

Draft brief answers to each of the above questions.

Research and Discussion Case

LO 19-6

19–39. You are a young CPA just starting your own practice in Hollywood, California, after five years' experience with a "Big 4" firm. You have several connections in the entertainment industry and hope to develop a practice rendering income tax, auditing, and accounting services to celebrities and other wealthy clients.

One of your first engagements is arranged by John Forbes, a long-established business manager for a number of celebrities and a personal friend of yours. You are engaged to audit the personal statement of financial condition (balance sheet) of Dallas McBain, one of Forbes's clients. McBain is a popular rock star, with a net worth of approximately \$100 million. However, the star also has a reputation as an extreme recluse who is never seen in public except at performances.

Forbes handles all of McBain's business affairs, and all your communications with McBain are through Forbes. You have never met McBain personally and have no means of contacting the star directly. All of McBain's business records are maintained at Forbes's office. Forbes also issues checks for many of McBain's personal expenses, using a check-signing machine and a facsimile plate of McBain's signature.

During the audit, you notice that during the year, numerous checks totaling approximately \$500,000 have been issued payable to Cash. In addition, the proceeds of a \$250,000 sale of marketable securities were never deposited in any of McBain's bank accounts. In the accounting records, all of these amounts have been charged to the account entitled "Personal Living Expenses." There is no further documentation of these disbursements.

When you bring these items to Forbes's attention, he explains that celebrities such as McBain often spend a lot of cash supporting various "hangers-on," whom they don't want identified by name. He also states, "Off the record, some of these people also have some very expensive habits." He points out, however, that you are auditing only the statement of assets and liabilities, not McBain's revenue or expenses. Furthermore, the amount of these transactions is not material in relation to McBain's net worth.

- a. Discuss whether the undocumented disbursements and the missing securities' proceeds should be of concern to you in a balance sheet-only audit.
- b. Identify the various courses of action that you might at least consider under these circumstances. Explain briefly the arguments supporting each course of action.
- c. Explain what you would do and justify your decision.
- d. Assume that you are a long-established CPA, independently wealthy, and that the McBain account represents less than 5 percent of the annual revenue of your practice. Would this change in circumstances affect your conclusion in part (c)? Discuss.

Supplementary References

This textbook; discussion of *1136 Tenants Corporation* case; Chapter 4, "CPAs' Liability to Their Clients under Common Law"; and Chapter 19, "Audits of Personal Financial Statements."

AICPA, *Personal Financial Statements Guide* (New York, 2009). AICPA AU-C 265, "Communicating Internal Control Related Matters Identified in an Audit."

Additional Assurance Services: Other Information

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 20-1** Describe the differences among assurance services, attestation services, and audits.
- LO 20-2** Explain the applicability of the attestation standards.
- LO 20-3** Describe the nature of attestation engagements, including examinations, reviews, and agreed-upon procedures engagements.
- LO 20-4** Describe the nature of trust services.
- LO 20-5** Describe the nature of system and organization controls (SOC) services.
- LO 20-6** Describe additional assurance services provided by CPAs.

To this point, we have focused primarily on services involving historical financial information, but CPAs are often asked to provide a wide range of other assurance services. In this chapter, we first focus on the broad concept of assurance services. Next, we address the attestation standards, which apply to a majority of the assurance services. Finally, we provide a detailed description of a number of existing and developing services.

Assurance Services

LO 20-1

Describe the differences among assurance services, attestation services, and audits.

Assurance services provided by CPAs are professional services that are meant to improve the quality of information or its context for decision makers and other users.¹

The AICPA's Assurance Standards Executive Committee describes its mission as seeking to support the profession in serving the public interest by continuously anticipating, identifying, assessing, and addressing evolving market needs and demand for assurance and advisory solutions. As such, the Committee is involved with developing assurance services that are meant to assure the quality, relevance, and usefulness of information or its context for decision makers and other users.

As discussed in Chapter 1, assurance services go beyond attestation services. Figure 20.1 illustrates that while assurance services encompass audits of financial statements and all other attestation services, the concept also includes additional services. Assurance services may involve analyzing data or putting them in a form to facilitate decision making. For example, CPAs may collect information that is generally considered to be relevant to a particular decision and synthesize it for the user. CPAs also may provide assurance that the user has a complete set of information with which to make a decision. In an assurance engagement, a report may or may not be issued and, if one is issued, it could be in oral, symbolic, or any other appropriate form.

Attestation services include examinations, reviews, and agreed-upon procedures engagements.² In an attest engagement, the practitioner must evaluate the subject matter of the engagement against **suitable criteria**.³ Figure 20.2 summarizes selected characteristics of the various types of assurance engagements.

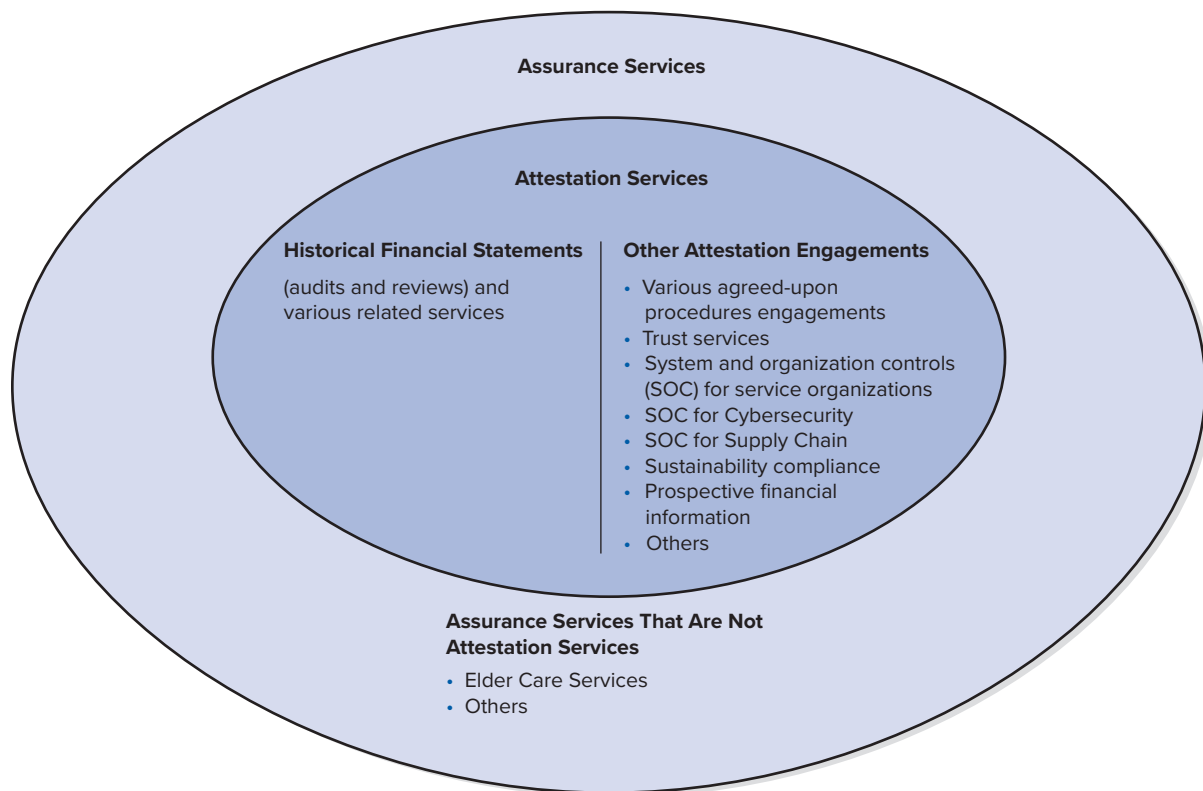
¹ CPAs are not alone in the role of providing assurance. Although a wide variety of examples are possible, consider information available on a wide variety of products from Consumers Union (www.consumerreports.org); automobile reliability provided by organizations such as Edmunds Inc. (e.g., www.edmunds.com); and restaurant quality from Zagat Survey (www.zagat.com). Also, because of the wide variety of assurance services provided that are discussed in this chapter, we use either *CPA* or *practitioner* rather than *auditor* throughout this chapter.

² The AICPA *Code of Professional Conduct* (ET 40.04) defines attestation services more generally as engagements that require independence as set forth in the AICPA *Professional Standards*.

³ Recall that financial statements are prepared following an appropriate *financial reporting framework*. The suitable criteria concept is the generalization of that term to include information other than financial statements. This concept is discussed further later in this chapter.

	Illustrative Case	Types of Assurance Services
In a survey of 21 large- and medium-sized CPA firms, the Special Committee on Assurance Services identified over 275 types of	A wide variety of assurance services are currently being performed by accounting firms.	assurance services. A few examples will provide an identification of the breadth of the subject matter of these engagements: (a) customer satisfaction, (b) investment performance, (c) software functionality, (d) effectiveness of risk management, (e) clinical results of in-vitro fertilization, and (f) the distance that golf balls travel.

FIGURE 20.1 The Relationship between Assurance Services and Attestation Services



The Demand for Assurance Services

The demand for new types of assurance services developed as a natural extension of the audit function. Management realized that contracting costs could be reduced in many situations by providing investors, creditors, customers, and others transacting with the company access to information that is *certified* as to its reliability. As with an audit, these new assurance services reduce information risk for the outside parties and thus enable the company to contract at more favorable terms.

Much of the demand for other assurance services arises from developments in information technology. The fact that users can now instantaneously access a broad range of online information customized to their needs certainly has current and expected future implications for CPAs. Decision makers demand timely assurance about a wide range of financial and nonfinancial information. As CPAs increase their expertise in the application of data analytics, they are providing more assurance and consulting services in this area. Using this expertise, CPAs are increasingly being engaged to put information in formats that help improve decision making.

FIGURE 20.2 Selected Characteristics of Assurance Services

	Assurance Services		
	Assurance Services That Are Attestation Services		Other Assurance Services
	Historical Financial Statement-Related Information	Other Attestation Engagements	
Primary Source of Standards	Auditing standards Review standards (SSARS)	Attestation standards	General performance standards of AICPA <i>Code of Professional Conduct</i> (Rule 201)
Nature	Providing assurance on the reliability of historical financial statement information	Providing assurance on the reliability of subject matter, or an assertion about subject matter, that is the responsibility of another party (other than historical financial information)	Independent professional services that assure the quality, relevance, and usefulness of information or its context
Primary Forms of Engagements	Audits Reviews Agreed-upon procedures	Examinations Reviews Agreed-upon procedures	No specific forms have been developed; intended to be flexible
Form of Report	Written	Written	Any reasonable form of communication
Type of Conclusion	Reliability of information	Reliability of information	May be reliability of information, but may address broader concept such as relevance to a decision
Is Independence Required?	Yes	Yes	Yes

To date, a number of assurance services have been developed. Many of these new services are performed currently in accordance with the *Statements on Standards for Attestation Services*. We will describe a number of these services later in this chapter.

Attestation Standards

LO 20-2

Explain the applicability of the attestation standards.

The AICPA and PCAOB attestation standards apply to engagements in which practitioners are engaged to issue or do issue an examination, a review, or an agreed-upon procedures report on subject matter, or an assertion about subject matter. It is important to distinguish between the subject matter and the assertion about the subject matter. The **subject matter** of an **attestation engagement** may take many forms, including

- Historical or prospective performance or condition (e.g., historical prospective financial information, performance measurements, and backlog data).
- Physical characteristics (e.g., narrative descriptions, square footage of facilities).
- Historical events (e.g., price of a market basket of goods on a certain date).
- Analyses (e.g., break-even analyses).
- Systems or processes (e.g., internal control).
- Behavior (e.g., corporate governance, compliance with laws and regulations, and human resource practices).

Generally, practitioners may attest to this subject matter at a point in time or for a period of time.

An **assertion** is a declaration about whether the subject matter is presented in accordance with the **criteria**, which are the benchmarks used to measure or evaluate the subject matter. To perform an “assertion-based” attestation engagement, the practitioners generally must obtain an appropriate written assertion from the party responsible for the subject matter.⁴ For example, in an engagement addressing compliance with a particular contract, management (the **responsible party**) might perform the necessary measurements and evaluations (often with assistance of specialists) and be able to provide a written assertion that the company has complied with the contract’s requirements.

In most assertion-based engagements, the CPAs may report on either the *subject matter itself* or an *assertion about the subject matter*. To illustrate, assume that an investment company prepares a schedule with its investment returns and engages the CPAs to perform an examination on that schedule. The practitioner’s opinion may include assurance directly on the related schedule. Alternatively, when reporting on the assertion, the practitioner’s opinion provides assurance on whether that assertion is properly stated. The following exhibit presents the two methods of reporting.⁵

Reporting on Subject Matter	Reporting on Assertion
In our opinion, the schedule presents fairly in all material respects the investment returns of XYZ Company for the year ended December 31, 20XX, based on the criteria set forth in Note 1.	In our opinion, XYZ Company’s assertion that the schedule presents the investment returns of XYZ Company for the year ended December 31, 20XX, based on the criteria set forth in Note 1, is fairly stated, in all material respects.

If the practitioners are reporting on an assertion about the subject matter, the assertion is presented with the subject matter or in the practitioners’ report. If the practitioners are reporting *directly* on the subject matter, the assertion normally is included only in a representation letter that the practitioners obtain from the responsible party.

There is an exception to the option of reporting upon the subject matter *or* on management’s assertion. When the examination reveals material departures from the suitable criteria, to most effectively communicate with the reader of the report, the practitioner should report upon the subject matter, and not on the assertion.

The Criteria

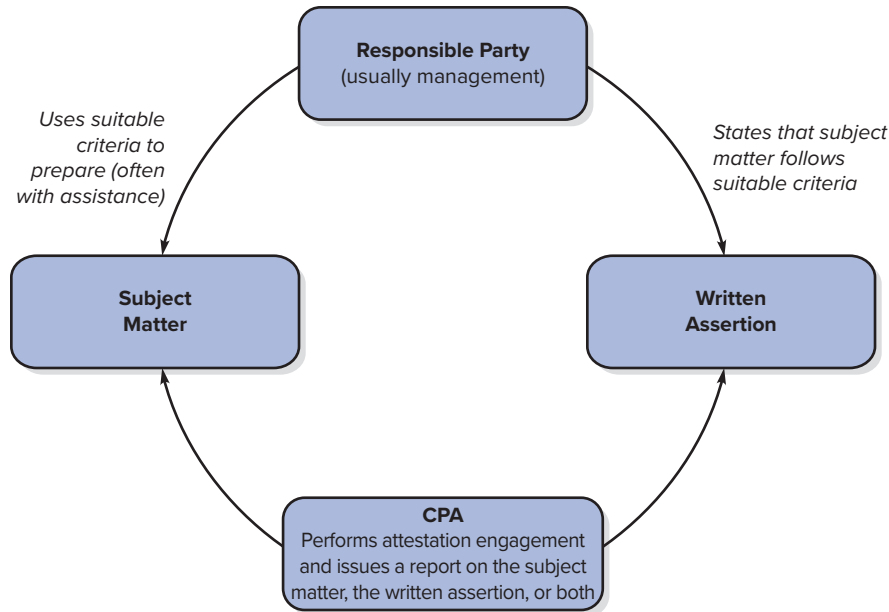
Criteria are standards or benchmarks that are used to evaluate the subject matter of the engagement. Criteria are important in reporting the practitioners’ conclusion to the users because they convey the basis on which the conclusion was formed. Without this frame of reference, the practitioners’ report is subject to misinterpretation. For example, generally accepted accounting principles are ordinarily used as the frame of reference—the criteria—to evaluate financial statements.

In most areas, however, the criteria are not as well established as are generally accepted accounting principles. Accordingly, a practitioner must evaluate the criteria being followed. The criteria used in an attestation engagement must be *suitable* and *available* to the users.

⁴ These are “assertion-based” attestation engagements in that an assertion is ordinarily required. The practitioner who is unable to obtain a written assertion from the responsible party in such an examination or review engagement is required to withdraw from the engagement, unless the engaging party is not the responsible party. Later in this chapter, we discuss “direct examinations,” which do not require an assertion.

⁵ While reporting on an assertion is often an option under both the AICPA and PCAOB attestation standards, which both require reporting on the financial statements (the subject matter), it is not an option under financial statement auditing standards. Also, there are other restrictions on reporting on an assertion. For example, as discussed in Chapter 18, when reporting on internal control over financial reporting, CPA reports are only on internal control (the subject matter).

FIGURE 20.3
Illustration of
Relationships
among Terms Used
in Assertion-Based
Attestation Engagements



Suitable Criteria

Suitable criteria are those that are *objective* and permit reasonably *consistent measurements*. In addition, the criteria must be sufficiently *complete* such that no relevant factors are omitted that would affect a conclusion about the subject matter. Finally, the criteria must measure some characteristic of the subject matter that is *relevant* to a user's decision.

Criteria are ordinarily suitable if they are developed by regulatory agencies or other bodies composed of experts that use due process, including exposing the proposed criteria for public comment. For example, the Committee of Sponsoring Organizations (COSO), discussed in Chapter 7, is an organization that followed due process in the development of its control criteria pertaining to internal control. Figure 20.3 illustrates the relationships among the responsible party, suitable criteria, subject matter, the written assertion, and the CPA's attestation engagement and report in an assertion-based engagement.

Criteria developed by management or industry groups without due process may be suitable, but the practitioner should carefully evaluate them in relation to the characteristics described in the previous two paragraphs. Criteria that are overly subjective should not be used in an attestation engagement. For example, an assertion that a particular software product is the *best on the market* is too subjective for an attestation engagement. There are no generally accepted criteria for what constitutes the *best* software product.

Some criteria for evaluating subject matter may be suitable only for those who established them (referred to as *specified parties*). As such, they are not suitable for *general use*. For example, criteria developed based on a lengthy, involved contract between two parties might result in a report whose use is restricted to the two parties. In such situations, the attestation report should be *restricted* to the use of the specified parties.

Available Criteria

In addition to meeting the requirement that they be *suitable*, the criteria also must be *available* to users. This requirement of availability has two parts in that, not only must the criteria be available, but they also must be understandable to users. The criteria may be made *available and understandable* to the users in a variety of ways. If the criteria were developed by a regulatory agency or an expert body using due process, it is likely that they are publicly available to users; it ordinarily is presumed that such criteria are understandable.

Alternatively, the criteria may be made available to the users in the presentation of the subject matter, in the assertion, or in the practitioners' report. Making the criteria available in one of these manners is particularly important when there is no "generally accepted" way of evaluating the related subject matter. Take, for example, the subject

matter of customer satisfaction. There are a number of possible measures of customer satisfaction, including customer opinion, rate of customer referral, rate of return customer sales, and increase in dollar amount of sales to existing customers. Particular criteria might employ one or more of these or other customer satisfaction measures. If the practitioner found the criteria being followed to be suitable, the presentation of the subject matter on customer satisfaction would most likely include the criteria describing the way in which customer satisfaction was defined and measured.

When criteria are available only to certain users, the practitioners' report should be restricted to those *specified parties*. Here again, a contract between two parties provides a good illustration. In the preceding section on suitable criteria, we suggested that the provisions of a contract may not be suitable for those who are not a party to the contract. Therefore, we find that the report on the provisions is generally restricted. These situations often have in common the fact that they have been developed by and agreed to by the parties to the engagement and are not generally understandable to, or usable for, those not involved.

Direct Reporting without the Assertion

The requirement that the responsible party generally must measure or evaluate ("prepare") the subject matter using the criteria and provide a written assertion on that subject matter has sometimes proven problematical. There are situations in which the responsible party may lack the skills and support necessary to fully measure or evaluate the subject matter so as to be able to provide a meaningful written assertion relating to that subject matter. In other situations, the responsible party may simply wish to engage the CPA to measure or evaluate the underlying subject matter against the criteria and also provide an attestation report on the results of that measurement or evaluation.

To address such situations, in 2020 the AICPA Auditing Standard Board passed an attestation standard (*Statement on Standards for Attestation Engagements (SSAE) 21*, AT-C 206) that allows another type of attestation service, **direct examination engagements** for nonpublic companies, engagements in which no assertion is obtained by the CPAs. In a direct examination engagement, the CPAs both (1) measure or evaluate the *underlying subject matter*⁶ against the criteria and (2) express an opinion on the results of that measurement or evaluation. Recall our previous illustration of a *responsible party* that measured and evaluated investment returns and prepared a related schedule and the CPAs that performed an **assertion-based examination** and expressed an opinion on that schedule. In a direct examination engagement, the CPAs perform both services, measure or evaluate the underlying subject matter and also express an opinion on the results of the measurement or evaluation.⁷

The examples of possible direct engagements provided in AT-C 206 include (1) the above measurement of the rate of return on a company's investment transactions and (2) the evaluation of the safety practices of a day care center. The standard does not enable direct examinations for all services performed under the attestation standards. For example, it does not allow such direct engagements relating prospective financial information, compliance attestation, and certain service organization reports (engagements discussed later in this chapter).

⁶ Standards issued prior to this standard defined subject matter as the phenomenon that is measured or evaluated by applying criteria. SSAE No. 21, consistent with *International Standard on Assurance Engagements 3000 (revised)*, breaks down subject matter into two parts:

- *Underlying subject matter*—the phenomenon measured or evaluated by applying criteria. In all attestation engagements, the underlying subject matter is the responsibility of a party other than the practitioner.
- *Subject matter information*—the outcome of the measurement or evaluation of underlying subject matter against criteria.

Most current AICPA Auditing Standards Board standards still include the term subject matter, which encompasses both underlying subject matter and subject matter information. PCAOB standards use the term subject matter.

⁷ The AICPA Auditing Standards Board intends to consider broadening its attestation standards to allow direct reporting for reviews in the future.

Attestation Risk and Materiality

Attestation risk is the risk that the practitioners will unknowingly fail to appropriately modify their report on subject matter that is materially misstated. Like audit risk, attestation risk consists of three components: inherent risk, control risk, and detection risk. In this context, *inherent risk* is the risk that the subject matter is materially misstated before considering any internal control. *Control risk* is the risk that internal control will fail to prevent or detect a material misstatement of the subject matter, and *detection risk* is the risk that the practitioners' procedures will fail to detect a material misstatement of the subject matter. In an attestation engagement, the practitioners assess inherent and control risks and design procedures to restrict detection risk to the appropriate level.

Determining materiality for an attestation engagement may be very difficult because the subject matter may not be financial in nature. In fact, the subject matter may not even be presented in quantitative terms. As an example, the practitioners may be attesting to material compliance with specific provisions of a regulation. To determine what is material for planning and reporting purposes, the practitioners must attempt to determine the likely needs of the intended users and consider the extent and nature of misstatements of the subject matter that would be significant to their decisions.

Materiality for the engagement may be considered in the context of quantitative or qualitative factors. If the subject matter is quantitative, materiality should generally be a relative rather than an absolute amount. That is, as the quantitative amounts of the presentation increase, the amount considered to be material also should increase. For qualitative subject matter, the practitioners must use professional judgment to consider what omission or misstatement would have a significant effect on the presentation of the subject matter.

The Character of the Engagement

LO 20-3

Describe the nature of attestation engagements, including examinations, reviews, and agreed-upon procedures engagements.

The practitioners should issue an attestation report that clearly describes the nature of the assurance being provided as an *examination*, a *review*, or the performance of *agreed-upon procedures*.

Examinations

An **examination** is designed to obtain reasonable assurance—the level of assurance a financial statement audit provides. In conducting an examination, the practitioners identify and assess risks of material misstatement as the basis for designing and performing further procedures. The nature of the subject matter determines the possible examination procedures, which may include performing inquiry, inspection, observation, confirmation, recalculation, reperformance, and analytical procedures to obtain sufficient evidence to drive attestation risk to an appropriately low level.

At the completion of the examination, the practitioners issue an appropriate report. Figure 20.4 illustrates an annotated standard unmodified examination report *directly on the subject matter*. The standard report, however, is not appropriate in all cases. The following table illustrates circumstances that result in modification of the standard unmodified report.

Situation	Report Modification
1. Criteria are agreed upon or only available to specified parties.	A statement of limitations on the use of the report.
2. Departure of subject matter from criteria.	Qualified opinion when effect is material but not pervasive; adverse opinion when material and pervasive.
3. Limitation on scope of engagement and auditor unable to perform adequate alternate procedure(s).	Qualified opinion or disclaimer. Alternatively, the practitioner may withdraw from the engagement.
4. The engaging party refuses to provide a written assertion.	If the engaging party is the responsible party, withdraw from engagement (if legally possible); if considered appropriate, a direct examination engagement may be performed. If the engaging party is not the responsible party, (1) disclose refusal in examination report and (2) restrict use of report to engaging party.

FIGURE 20.4 Unmodified Examination Report on Subject Matter*

Independent Accountant's Report
We have examined the accompanying schedule of investment performance returns of Terrill Investment Fund for the year ended December 31, 20X2. Terrill Investment Fund's management is responsible for presenting the schedule of investment performance returns in accordance with the Association of Investment Management Research Inc. Investment Reporting Criteria set forth in Note 1. Our responsibility is to express an opinion on the schedule of investment performance returns based on our examination.
Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance that the schedule of investment performance returns is in accordance with the criteria, in all material respects. An examination involves performing procedures to obtain evidence about the schedule of investment performance returns. The nature, timing, and extent of the procedures selected depend on our judgment, including an assessment of the risks of material misstatement of investment performance returns whether due to fraud or error. We believe that our examination provides a reasonable basis for our opinion.
We are required to be independent of the Terrill Investment Fund and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our examination.
In our opinion, the schedule of investment performance returns of Terrill Investment Fund for the year ended December 31, 20X2 is presented in accordance with the Association of Investment Management Research Inc. Investment Reporting Criteria set forth in Note 1, in all material respects.
<i>Wesley & Ward, LLP</i> Minneapolis, Minnesota January 22, 20X3

*This example report is for an examination engagement in which the responsible party has measured or evaluated the subject matter and provided a written assertion—an “assertion-based” examination. A direct examination report would also include information that the CPAs prepared the schedule of investment performance returns and describe the nature of a direct examination.

Reviews

A **review** engagement involves performing limited procedures, such as inquiries and analytical procedures. In performing a review, the practitioners endeavor to gather sufficient evidence to drive attestation risk to a *moderate level*. Accordingly, the resulting report provides only limited assurance that the information is fairly presented. As we discussed in Chapter 19, **limited assurance** is sometimes informally referred to as **negative assurance** because the practitioners’ report disclaims an opinion on the reviewed information but includes a statement such as, “We are not aware of any material modifications that should be made in order for the information to be in conformity with the criteria.” An example of an annotated unmodified review report *directly on the subject matter* is presented in Figure 20.5. Of course, when an uncorrected material departure from the criteria is noted, the report must be modified to describe the departure.

While the professional standards establish examinations and reviews for many types of engagements, the review form of association is not allowed for engagements involving (1) prospective financial information, (2) internal control, and (3) compliance with requirements of specified laws, regulations, rules, contracts, or grants. This restriction is based on the nature of these types of subject matter. They seemingly do not lend themselves to the application of adequate analytical procedures to provide sufficient appropriate review evidence.

The reporting options are similar to those for examination reports as presented in the preceding section, although reviews result in a “conclusion” rather than an opinion (e.g., a qualified conclusion rather than qualified opinion). Also, at this point there is no direct review engagement option available.

Agreed-Upon Procedures

As discussed in Chapter 19, practitioners also may be engaged to perform an **agreed-upon procedures engagement**. Recall that the engaging party and the practitioners determine

FIGURE 20.5 Unmodified Review Report on Subject Matter

Independent Accountant's Report
To the Board of Directors, Keller Investment Fund
We have reviewed the accompanying schedule of investment performance returns of Keller Investment Fund for the year ended December 31, 20X2. Keller Investment Fund's management is responsible for the preparation of the schedule of investment performance returns in accordance with the Association of Investment Management Research Inc. Investment Reporting Criteria (the criteria) set forth in Note 1. Our responsibility is to express a conclusion on the schedule of investment performance returns based on our review.
We conducted our review in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the review to obtain limited assurance about whether any material modifications should be made to the schedule of investment performance returns in order for it to be in accordance with the criteria.
The procedures performed in a review vary in nature and timing from, and are substantially less in extent than, an examination, the objective of which is to obtain reasonable assurance about whether the schedule of investment performance returns is in accordance with the criteria, in all material respects, in order to express an opinion. Accordingly, we do not express such an opinion. We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our conclusion.
We are required to be independent of the Keller Investment Fund and to meet our other ethical responsibilities in accordance with the relevant ethical responsibilities relating to our review.
The procedures we performed were based on our professional judgment and included inquiries, inspection of documents, analytical procedures, and agreeing of reconciling items with underlying records.
Based on our review, we are not aware of any material modifications that should be made to the accompanying schedule of investment performance returns of Keller Investment Fund for the year ended December 31, 20X2, in order for it to be in accordance with the Association of Investment Management Research Inc. Investment Reporting Criteria, as set forth in Note 1.
<i>George Little & Associates, LLP</i> Chicago, Illinois January 15, 20X3

the procedures to be performed, with the engaging party affirming that the procedures are appropriate to meet the engagement's intended purpose. Agreed-upon procedures reports include a list of procedures performed (or reference thereto) and the related findings. Also, in some cases the practitioner may consider it appropriate to restrict the use of the report to specified parties.

Assurance Service Examples

Trust Services

LO 20-4

Describe the nature of trust services.

Information technology has a profound effect on the way in which companies do business. Increasingly, companies have developed technology-enabled systems that not only maintain historical information but also produce products and services, directly interact with customers and suppliers, and run portions of the business. As a result, system reliability is of major concern not only to management but also to stockholders, creditors, business partners, and other stakeholders in the company. The public accounting profession has developed a set of **trust services** that are defined as a set of professional attestation and advisory services based on a core set of criteria related to security, availability, processing integrity, confidentiality, or privacy.

While systems engagements using one or more of the trust services criteria are ordinarily structured under the attestation standards as examinations or agreed-upon procedures engagements (our emphasis in this chapter), the trust services criteria are also used in certain consulting services engagements. For example, such a consulting engagement may involve performance of services in which a practitioner assists management with the implementation of one or more new information systems within an organization.

In a consulting engagement, the practitioner generally develops findings and makes recommendations for the consideration and use of management but does not form a conclusion about or express an opinion on the subject matter of the engagement. The emphasis of consulting services is for the use and benefit of the client. Consulting standards are titled *Statements on Standards for Consulting Services* and codified with a “CS.” In the remainder of this section, we emphasize trust services attestation engagements.

Trust services attestation engagements are intended to help companies to demonstrate that they are attuned to the risks posed by their environment and that they are equipped with controls that address those risks. There are potentially a wide range of beneficiaries of trust services assurance reports, including consumers, business partners, bankers, creditors, regulators, and outsourcers. With trust services, jointly developed by the AICPA and the then Canadian Institute of Chartered Accountants (CICA) (now Chartered Professional Accountants Canada), practitioners examine a system’s controls and attest to the system’s reliability. This is a part of a broader future vision of the accounting profession to supply real-time assurance on information databases and systems and is viewed as a natural extension of the CPA’s audit and information technology consulting functions.

In a trust services attestation engagement, management prepares and communicates a description of the aspects of the system that are to be encompassed by the practitioner’s engagement. Management’s description can be included on the company’s website, attached to the practitioners’ report, or communicated to users in some other manner. It must clearly articulate the boundaries of the system to allow individuals to understand both the scope of management’s assertions related to it and the practitioners’ report.

Performing a Trust Services Engagement

A typical trust services engagement addresses (1) whether management’s description of the system is fairly stated, (2) the suitability of design of the controls, and, often, (3) the operating effectiveness of controls to meet the trust services criteria—the suitable criteria required for an attest engagement. The trust services criteria are aligned with the guidance provided in the Committee of Sponsoring Organization’s *Internal Control—Integrated Framework* (COSO) discussed in Chapter 7. In essence, the trust services criteria supplement the more general COSO guidance. The evidence obtained in a trust services engagement should bear on whether the system meets one or more of the following categories of criteria over a particular reporting period:

1. *Security*. The information and systems are protected against unauthorized access, unauthorized disclosure of information, and damage to systems that could compromise the availability, integrity, confidentiality, and privacy of information or systems and affect the entity’s ability to meet its objectives.
2. *Availability*. The information used by the entity’s systems and the products or services provided to its customers are accessible.
3. *Processing integrity*. System processing is complete, accurate, timely, and authorized.
4. *Confidentiality*. Information designated as confidential is protected as committed or agreed upon.
5. *Privacy*. Personal information is collected, used, retained, disclosed, and destroyed in conformity with the commitments in the entity’s privacy notice and with criteria set forth in generally accepted privacy principles issued by the AICPA and Canadian Institute of Chartered Accountants (CICA).⁸

It is helpful to recognize that the above trust services criteria provide “suitable measurement criteria” (e.g., think of GAAP in a financial statement audit), while the attestation standards often are used to provide standards for examinations and agreed-upon procedures engagements (think of GAAS).

⁸ Although confidentiality applies to various types of sensitive information, privacy applies only to private information.



Illustrative Case

Development of Trust Services

In the late 1990s, the AICPA and the CICA jointly developed standards for two early types of services of what would ultimately be referred to as trust services: **WebTrust** and **SysTrust**.

WebTrust was designed to promote confidence and trust between consumers and companies when conducting business on the Internet by providing principles and criteria for such systems and accountant reporting options. **SysTrust** was designed to provide assurance on system reliability using

standard principles and criteria for all engagements on electronic system reliability. Both services were developed to include examination or agreed-upon procedures engagements. In 2003 the AICPA and CICA merged the previous versions of the **WebTrust** and **SysTrust** Principles and Criteria to form what is now referred to as the trust services criteria. Nonetheless, a limited number of companies still ask their CPAs to perform **WebTrust** engagements (e.g., a **WebTrust** engagement for DigiCert at <https://www.digicert.com/webtrust-audits/>). We are not aware of continuing **SysTrust** engagements.

System and Organization Controls (SOC) Engagements

LO 20-5

Describe the nature of system and organization controls (SOC) services.

In system and organization controls (SOC⁹) engagements, CPAs provide a report that addresses system-level controls of a *service organization* or entity-level controls of *other organizations*. Service organizations provide a variety of services to customers, many of which involve outsourcing of data processing. Examples of services that are typically outsourced include **cloud computing** services, payroll processing services, information security services, and information system services. In Chapter 7 we discussed service organizations as they relate to audits of financial statements. A variety of services might be considered for other organizations. Currently the AICPA has developed the following SOC engagements:

- SOC for Service Organizations
 - SOC 1: Restricted-use reports on controls at a service organization relevant to a user entity's internal control over financial reporting (presented earlier in Chapter 7).
 - SOC 2: Restricted-use reports on controls at a service organization related to security, availability, processing integrity, confidentiality, and/or privacy.
 - SOC 3: General-use reports on controls at a service organization related to security, availability, processing integrity, confidentiality, and/or privacy.
- SOC for Cybersecurity
- SOC for Supply Chain

All of these services are based on auditors having performed examinations of the related system and information.

SOC 1 Reports

SOC 1 reports are issued under AICPA AT-C 320 (PCAOB AS 2601). Chapter 7 and Chapter 16 of this text include discussions of reports of **service auditors** when an audit client has outsourced a portion of its processing to a service organization. Chapter 7 presented an example of a company outsourcing its payroll function to a service organization and Chapter 16 addressed the overall payroll function (including outsourcing it), and the auditing of payroll. Service organizations may engage their auditors to study their internal control over financial reporting relating to their processing services and to issue a service auditor's report on that internal control. As discussed in Chapter 2, These reports may be either a

- Report on controls placed in operation (**Type 1 report**).
- Report on controls placed in operation and tests of controls (**Type 2 report**).¹⁰

⁹In 2017 the AICPA redefined the SOC acronym from "service organization controls" to "system and organization controls."

¹⁰As we indicate in Chapter 2, the PCAOB uses the terms "report on controls placed in operation" and "report on controls placed in operation and tests of operating effectiveness," while the AICPA uses "Type 1" and "Type 2." We use the AICPA terms.

Auditors of the financial statements of companies that use the services of a service organization (referred to as “user auditors”) generally use the service auditor report when assessing their client’s internal control. SOC 1 reports are restricted-use reports ordinarily meant for communication between the service auditor and the user auditor or the user organization.

SOC 2 Reports

SOC 2 reports provide assurance on one or more of the trust services criteria of security, availability, processing integrity, confidentiality, and privacy. These reports are designed to provide

- Organizations that outsource tasks and functions a mechanism for improving governance and oversight of service providers.
- Service organizations the ability to communicate the suitability of the design and operating effectiveness of their controls.

In a SOC 2 engagement, management prepares a detailed description of the service organization’s system, including controls designed to achieve the criteria for one or more of the trust services criteria, and the CPA reports on the fairness of the description. Service organizations can distribute the report to their customers and other intended recipients, such as regulators and business partners. As is the case with SOC 1 reports, the CPAs may be engaged to issue either a Type 1 or Type 2 report.

SOC 3 Reports

SOC 3 reports are also ordinarily trust services criteria reports. These reports provide users with an assertion by management that it maintained effective controls to meet the trust services criteria, a short description of its system, and a CPA’s report on either management’s assertion or the effectiveness of controls in meeting the trust services criteria as described earlier in this chapter. SOC 3 reports are all Type 2 reports. Following is a SOC 3 report issued to Amazon Web Services, Inc., a company that has its report updated every six months. This report provides a good example of details of the type of assurance provided by CPAs in a report that is meant to be generally available relating to an organization’s compliance with the trust services criteria. The first two pages of the report (as shown) defines the parameters of the report, indicating what was evaluated and what was not, such as AWS’s cybersecurity risk management program. It also discusses any inherent limitations, such as human fallibility/social engineering and lack of resources to fight off persistent, advanced, and unpredicted attacks, and then it gives a final evaluation of the effectiveness of AWS’s controls over the system in a specific time frame. The documentation that appears in the rest of the report supports the CPAs’ conclusions made in the first two pages of the report.

Report of Independent Accountants

To the Management of Amazon Web Services, Inc.

Scope

We have examined management’s assertion, contained within the accompanying “Management’s Report of its Assertions on the Effectiveness of Its Controls Over the Amazon Web Services System Based on the Trust Services Criteria is for Security, Availability, and Confidentiality” (Assertion), that Amazon Web Services, Inc.’s (AWS) Controls over the Amazon Web Services System (System) were effective throughout the period October 1, 20X1, to March 31, 20X2, to provide reasonable assurance that its principal service commitments and system requirements were achieved based on the criteria relevant to security, availability, and confidentiality (applicable trust services criteria) set forth in the AICPA’s TSP section 100, 2017 *Trust Services Criteria for Security, Availability, Processing Integrity, Confidentiality, and Privacy*.

Management's Responsibilities

AWS' management is responsible for its assertion, selecting the trust services categories and associated criteria on which its assertion is based, and having a reasonable basis for its assertion. It is also responsible for:

- Identifying the Amazon Web Services System and describing the boundaries of the System.
- Identifying our principal service commitments and system requirements and the risks that would threaten the achievement of its principal service commitments and service requirements that are the objectives of our system.
- Identifying, designing, implementing, operating, and monitoring effective controls over the Amazon Web Services System to mitigate risks that threaten the achievement of the principal service commitments and system requirements.

Our Responsibilities

Our responsibility is to express an opinion on the Assertion, based on our examination. Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform our examination to obtain reasonable assurance about whether management's assertion is fairly stated, in all material respects. An examination involves performing procedures to obtain evidence about management's assertion, which includes (1) obtaining an understanding of AWS' relevant security, availability, and confidentiality policies, processes, and controls, (2) testing and evaluating the operating effectiveness of the controls, and (3) performing such other procedures as we considered necessary in the circumstances. The nature, timing, and extent of the procedures selected depend on our judgment, including an assessment of the risk of material misstatement, whether due to fraud or error. We believe that the evidence obtained during our examination is sufficient to provide a reasonable basis for our opinion.

Our examination was not conducted for the purpose of evaluating AWS' cybersecurity risk management program. Accordingly, we do not express an opinion or any other form of assurance on its cybersecurity risk management program.

Inherent limitations:

Because of their nature and inherent limitations, controls may not prevent, or detect and correct all misstatements that may be considered relevant. Furthermore, the projection of any evaluations of effectiveness to future periods, or conclusions about the suitability of the design of the controls to achieve AWS' principal service commitments and system requirements, is subject to the risk that controls may become inadequate because of changes in conditions, that the degree of compliance with such controls may deteriorate, or that changes made to the system or controls, or the failure to make needed changes to the system or controls, may alter the validity of such evaluations. Examples of inherent limitations of internal controls related to security include (a) vulnerabilities in information technology components as a result of design by their manufacturer or developer; (b) breakdown of internal control at a vendor or business partner; and (c) persistent attackers with the resources to use advanced technical means and sophisticated social engineering techniques specifically targeting the entity.

Opinion:

In our opinion AWS' controls over the system were effective throughout the period October 1, 20X1, to March 31, 20X2, to provide reasonable assurance that its principal service commitments and system requirements were achieved based on the applicable trust services criteria.

(CPA Firm Signature)

May 12, 20X2.

Figure 20.6 compares the three SOC reports for service organization and related information.

SOC for Cybersecurity

The rapidly evolving area of information technology and the ever-increasing skills of hackers have made **cybersecurity** one of the most important areas of risk management for businesses. A cybersecurity examination provides users with information about a business's cybersecurity risk management program. Guidance has been developed for CPAs to provide two types of cybersecurity examinations: (1) a SOC for cybersecurity examination and (2) a SOC 2 examination.

FIGURE 20.6 Comparison of Types of System and Organization Controls (SOC) Reporting

	SOC 1	SOC 2	SOC 3
Professional Standards (in addition to attestation standards)	• AT-C 320 • <i>Service Organizations: Reporting on Controls at a Service Organization Relevant to Entities' Internal Control over Financial Reporting Guide</i>	• Trust services criteria • <i>Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy</i>	• Trust services criteria
Primary Purpose	Report on service organization controls over financial reporting, particularly on those controls likely to be relevant to user entities' financial statements	Report on service organization controls related to compliance with the trust services criteria and criteria (controls over security, availability, processing integrity, confidentiality, and/or privacy)	
Assertion Provided by Service Organization Management	A detailed assertion on details of the system		A more general assertion on the organization having met one or more of the AICPA trust services criteria
Report*	Detailed Type 1 or Type 2 report on controls tested	Detailed Type 1 or Type 2 report on service organization's compliance with one or more trust services criteria	A less detailed report on whether the service organization maintained effective controls based on the trust services criteria
Use of Report	Restricted-use report primarily for user auditors (auditors auditing the financial statements of companies that use the service auditor)	Restricted-use report primarily for service organization and user stakeholders such as customers, regulators, business partners, suppliers, and directors	General-use report (for use by anyone)

*Type 1 reports address whether the description of the controls is fairly presented and whether the controls described are suitably designed. A Type 2 report includes the information in a Type 1 report and an opinion on whether the controls were operating effectively.

The AICPA provides an illustrative report for a SOC for cybersecurity examination that provides an overview of the nature of such an engagement. The report includes:

- *Management's assertion.* The assertion states (a) the description of the program is presented in accordance with the AICPA *Description Criteria* and (b) the controls within the program are effective in achieving the entity's cybersecurity objectives based on the control criteria. Ordinarily, the service addresses the security, availability, and confidentiality criteria of trust services.
- *CPA's opinion.* The CPA's report includes an opinion on management's assertion. The report is appropriate for general use by all users.
- *Management's description.* Management provides a description of the organization's cybersecurity risk management program that is in accordance with the AICPA *Description Criteria*.

In a SOC 2 examination, management of a service organization presents a description of a specific system the service organization uses to process transactions for user organizations. Management also provides an assertion about whether (1) the description is presented in accordance the AICPA *Description Criteria* and (2) the controls stated in the description are suitably designed and operating effectively to provide reasonable assurance that the organization's service commitments and system requirements are achieved based on the trust services criteria. The CPA's (service auditors') report on this SOC 2

service provides an opinion on management's assertion and a description of the CPA's tests of controls and the results of those tests. This type of report may consider any or all trust services criteria. Because it is a SOC 2 examination, the report is restricted to use by the service organization and specified users who have a sufficient knowledge and understanding of the service organization and its system.

SOC for Supply Chain

A supply chain may be viewed as the steps involved in transforming a product or service from its original state to a form used by the customer. This process ordinarily involves individuals, organizations, resources, activities, and technology in the creation and sale of a product. This may begin with the delivery of raw materials from suppliers through manufacturing and subsequent delivery of the product to the user.

In 2020, the AICPA released a supply chain reporting framework. The objective of the framework is to provide a means for manufacturers, producers, and distribution companies to communicate useful information about their systems and controls to customers and business partners. CPAs can perform an examination on such information under the *AICPA Attestation Standards*.

The AICPA supply chain reporting framework may be viewed as including four components:

- *Management's description.* A description of the system the company uses to produce, manufacture, or distribute products in accordance with the *AICPA Description Criteria* for supply chain engagements. This includes providing information about the organization's objectives and risks and the processes and controls that address the risks.
- *Management's assertion.* Management's assertion that the system was designed and implemented throughout the period in accordance with the *Description Criteria* and that the controls were effective throughout the period, based on the applicable trust services criteria.
- *CPA's opinion.* The CPA's report includes an opinion on whether (a) management's description of the system is presented in accordance with the *Description Criteria* and (b) the controls were effective, based on the applicable trust services criteria.
- *CPA's procedures.* The CPA's description of the procedures performed and the related results.

The purpose of the CPAs' examination report is to provide specified users who have sufficient knowledge and understanding of the company and its system (e.g., management; current and prospective business partners and customers) with information about the controls within the company's system relevant to trust criteria of security, availability, processing integrity, confidentiality, or privacy. This is meant to enable such users to better understand and manage risks arising from business relationships with their supplier and distribution networks. Note that unlike a cybersecurity examination, which ordinarily is intended for general users, this report is restricted, as we have indicated.

Assurance on Sustainability Information

LO 20-6

Describe additional assurance services provided by CPAs.

Companies are increasingly disclosing information about the sustainability of their operations to meet the demand for such information by regulators and investors. The AICPA has developed a guide, *Attestation Engagements on Sustainability Information*, to provide guidance for CPAs when they are engaged to perform engagements to provide assurance on such information. A variety of differing sustainability reporting standards and frameworks have been developed. In Chapter 1 we provided a description of the **International Sustainability Standards Board (ISSB)**, which was formed to provide criteria for disclosure of sustainability information by companies. The standards of the ISSB are set through exposure and due process and, therefore, constitute **suitable criteria** for performing attestation engagements.

Assurance on Compliance

The attestation standards provide guidance for two types of compliance attestation engagements:

1. Attesting to an entity's compliance with specified requirements of laws, regulations, rules, contracts, or grants.
2. Attesting to the effectiveness of an entity's internal control over compliance with specified requirements.

Practitioners are permitted to perform an examination or agreed-upon procedures on such matters, but they are *prohibited* from performing reviews of compliance or internal control over compliance. These types of engagements and reports are described in detail in Chapter 21.

XBRL Engagements

XBRL, eXtensible Business Reporting Language, is an international information format designed specifically for business information, both financial and nonfinancial. It assigns individual disclosure items within business reports unique electronically readable tags that are mapped to taxonomies (e.g., for financial statements, tags relate to the various accounts and note disclosures).

XBRL potentially offers major benefits in the preparation, analysis, and communication of business information through its cost-effectiveness and improved reliability as compared to other existing systems. Indeed, a number of international regulatory agencies, including the Securities and Exchange Commission, have required certain filings to incorporate XBRL.

The AICPA has developed *Principles and Criteria for XBRL* to provide guidance to CPAs in providing assurance services on XBRL information.

Elder Care Services

The population of the United States is aging, with the greatest increase in adults over 65 years of age expected to occur between now and 2030. In response to these demographics, the AICPA and the Canadian Institute of Chartered Accountants developed **PrimePlus/ElderCare** services. While the term is not frequently used at this point, CPAs do provide a variety of consulting and assurance services that focus on the specific needs and goals of older adults. In providing these services, CPAs draw upon their strengths and competencies in a variety of areas, including accounting, cash flow planning and budgeting, pre- and postretirement planning, insurance reviews, estate planning, and tax planning. The intent is to help older Americans maintain, for as long as possible, their lifestyle and financial independence. The profession sees three primary markets for these services:

- Older clients of the CPA who have the financial resources to avail themselves of the services.
- The children of older adults who have the resources and interest to see that their loved ones are cared for.
- Other professionals who deal with older adults (e.g., lawyers and health care professionals).

The services involved are of two types: financial and nonfinancial. Financial services include goal-setting, funding analysis, cost management, and needs assessment. Nonfinancial services may involve interpersonal and relationship management, as well as management of the interaction between service providers and the client. Figure 20.7 provides more detailed examples of each of these services.

Assurance on Prospective Financial Statements

Securities analysts and loan officers give considerable attention to prospective financial statements. Although such statements may be presented in various forms, CPAs most frequently are involved *with financial forecasts and financial projections*. A **financial forecast** presents information about the entity's *expected* financial position, results of operations, and cash flows. On the other hand, a **financial projection** presents expected

FIGURE 20.7
Examples of Elder
Care Services

Financial Services	Nonfinancial Services
• Planning for fiduciary needs • Evaluating financing options • Receiving, depositing, and accounting for client receipts • Ensuring that expected revenues are received • Submitting claims to insurance companies • Protecting the elderly from predators • Estate planning • Income tax planning and preparation • Gift tax return preparation • Evaluating investments and trust activity • Portfolio management • Risk management and insurance planning	• Lifestyle planning • Lifestyle management services • Coordinating support and health care services • Functioning as the “quarterback” or as a member of the <i>PrimePlus/ElderCare</i> team—which consists of health care, legal, and other professionals • Helping family members monitor the elder’s care • Communicating family expectations to care providers • Establishing, in concert with the family, appropriate standards of care • Establishing performance monitoring systems

results, *given one or more hypothetical assumptions*. For example, a projection might present expected results assuming the company expanded its plant. While a forecast may be issued for general use, a projection’s use should be restricted to the party with whom the company is negotiating; for example, a bank that is considering loaning funds to the company to expand the plant. Both forecasts and projections must include certain minimum *prospective financial statement* items, background information, and a list of the major assumptions and accounting policies.

Users of forecasts and projections may request assurance that this forward-looking information is properly presented and based upon reasonable assumptions. To provide such assurance, CPAs may be engaged to examine prospective statements, or they may be asked to perform certain agreed-upon procedures or perform a compilation, but the attestation standards *prohibit* the review of prospective financial statements. Criteria for evaluation of the fairness of a forecast or projection are presented in AICPA AT-C 305 and include a set of presentation guidelines.¹¹

Examinations of Prospective Financial Statements

In an examination of prospective financial statements, the practitioners gather evidence relating to the client’s procedures for preparation of the statements, evaluate the underlying assumptions, obtain a written representation letter from the client, and evaluate whether the statements are presented in conformity with AICPA guidelines. The report issued is ordinarily on the subject matter and states whether, in the practitioners’ opinion, the statements are presented in conformity with AICPA guidelines and whether the underlying assumptions provide a reasonable basis for the statements. In no circumstance is the practitioners’ report to vouch for the achievability of the forecast or projection.

The standard report should be modified in the following situations:

Situation	Report Modification
1. Material departure from presentation criteria	Qualified or adverse opinion (if underlying assumptions are omitted, an adverse opinion should be issued)
2. One or more significant assumptions do not provide a reasonable basis for the prospective financial statements	Adverse opinion
3. Limitation on scope of engagement	Disclaimer of opinion

¹¹ Further details of required disclosures are presented in the AICPA’s *Guide for Prospective Financial Information* (New York, 2012).

The report on a financial projection is similar to the one illustrated for a forecast, but a paragraph is added prior to the opinion paragraph indicating that the use of the report should be restricted to the specified party. In addition, the opinion paragraph explicitly states the hypothetical assumptions.

Agreed-Upon Procedures on Prospective Financial Statements

Specific users may request the practitioners to perform certain agreed-upon procedures on prospective financial statements. In such circumstances, the practitioners may perform the procedures and provide a summary of findings.

Assurance on Management's Discussion and Analysis

Management of a public company is required to provide a narrative explanation of financial results as reported in the financial statements filed with the SEC. This narrative explanation, referred to as **Management's Discussion and Analysis (MD&A)**, is a required part of Form 10-K (for annual financial statements) and Form 10-Q (for interim financial statements) filed with the SEC. Practitioners may examine or review MD&A under the guidance of the attestation standards.

To accept an engagement to examine MD&A, the practitioners must have audited the most recent financial statement period to which the MD&A applies, and the other financial statement periods also must have been audited by them or other auditors. The practitioners' objective in such an engagement is to provide assurance on whether (1) the presentation includes, in all material respects, the required elements of the rules and regulations adopted by the SEC; (2) the historical financial amounts included in the presentation have been accurately derived, in all material respects, from the entity's financial statements; and (3) the underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures contained in the presentation. Practitioners also may be engaged to perform a review of MD&A for an annual or interim period. However, if a review is performed and the report is not intended to be filed with the SEC, it should be restricted as to use. At this point, despite being available for a number of years, few reports on MD&A have been issued.

Future Assurance Services

The AICPA, through its various committees, continues to consider and develop a number of other services to be provided by CPAs. Services that are still under development include assurance on health care performance measurement and continuous auditing.

Health Care Performance Measurement

Health care recipients and their employers are increasingly concerned about the quality and availability of health care services. This service provides assurance about the effectiveness of health care services provided by health maintenance organizations, hospitals, doctors, and other providers.

Continuous Auditing

A demand exists for assurance beyond that provided on quarterly and annual financial statements. **Continuous auditing** provides assurance using a series of reports provided simultaneously or shortly after the related information is released. Use of data analytics, as discussed throughout this text, is an approach that will be used for continuous auditing. For example, the data analytics approaches of external auditors examining entire populations for unusual transactions may be applied by company information systems that generate reports of such questionable transactions as, or shortly after, they occur. While still in its infancy, continuous auditing is expected to grow dramatically as companies provide more and more up-to-date financial information on their websites. Both internal and external auditors will be increasingly involved with continuous auditing in the future.

Chapter Summary

This chapter described assurance services, focusing on those that are governed by *Statements on Standards for Attestation Engagements*. To summarize:

1. Assurance services are defined as professional services that improve the quality of information, or its context, for decision makers. Assurance services go beyond attestation services in that they may involve analyzing data or putting data in a form to facilitate decision making, or they may address relevance to a decision.
2. The majority of currently provided assurance services are attestation services that are performed in accordance with *Statements on Standards for Attestation Engagements*. Examples include a number of engagements in the areas of trust services, compliance with laws and regulations, prospective financial statements, and management's discussion and analysis. Assurance services standards do not apply to professional services specifically covered by the following other standards: *Statements on Auditing Standards*, *Statements on Standards for Accounting and Review Services*, and *Statements on Standards for Consulting Services*. They also do not cover various types of tax services.
3. Attestation engagements include examinations, reviews, and agreed-upon procedures engagements. Examinations and reviews involve providing assurance about the correspondence of subject matter with suitable criteria. An agreed-upon procedures engagement involves performing procedures and issuing a report on the findings.
4. Trust services provide assurance on one or more of the following trust categories of criteria: (a) security, (b) availability, (c) processing integrity, (d) confidentiality, and (e) privacy. A number of attestation services have been structured under the trust services criteria.
5. CPAs also may report on system and organization controls (SOC). Three forms of reporting have been developed relating to service organizations: one based on a service organization's internal control over financial reporting and two based on the trust services criteria. In addition, SOC examination engagements using trust services criteria have been developed for cybersecurity and supply chain reporting.
6. Additional assurance services are provided by CPAs relating to a wide variety of areas, including sustainability information, compliance, XBRL engagements, elder care services, and assurance on prospective financial statements and MD&A.

Key Terms Introduced or Emphasized in Chapter 20

Agreed-upon procedures engagement (901) An attestation engagement in which a practitioner performs specific procedures on subject matter and reports the findings without providing an opinion or a conclusion on it.

Assertion (897) A declaration about whether subject matter is presented in accordance with certain criteria.

Assertion-based examination (899) An attestation examination engagement in which the practitioner obtains an assertion from the responsible party and performs examination procedures to obtain sufficient appropriate evidence to express an opinion about whether the underlying subject matter follows the criteria. Throughout the attestation section of the chapter, if the term "examination" is used by itself, it represents an assertion-based examination.

Assurance services (894) Professional services that improve the quality of information, or its context, for decision makers. Many assurance services involve some form of attestation.

Attestation engagement (896) An examination, review, or agreed-upon procedures engagement performed under the attestation standards.

Attestation risk (900) The risk that the practitioners will issue an unmodified report on subject matter that is materially misstated.

Cloud computing (904) A model for enabling on-demand user network access to a shared pool of computing resources (e.g., networks, servers, storage, applications, or services), often through an Internet browser. As an illustration, consider a model in which databases and the associated data are maintained by an independent provider and accessed by corporate users.

Continuous auditing (911) To provide assurance using a series of reports provided simultaneously or shortly after the related information is released.

Criteria (897) The benchmarks used to measure or evaluate the subject matter.

Cybersecurity (906) The technologies, processes, and practices designed to protect networks, computers, programs, and data from attack, damage, or unauthorized access.

Direct examination engagement (899) An attestation examination engagement in which the practitioner both (1) measures or evaluates (prepares) the underlying subject matter using the criteria and (2) performs other procedures to obtain sufficient appropriate evidence to express an opinion about whether the underlying subject matter follows the criteria. In a direct examination engagement, the responsible party does not provide an assertion.

Examination (900) An attestation engagement designed to obtain assurance that CPAs provide on subject matter or an assertion about the subject matter. An examination of financial statements is referred to as an audit.

Financial forecast (909) Prospective financial statements that present an entity's expected financial position, results of operations, and cash flows for one or more future periods.

Financial projection (909) Prospective financial statements that present expected results, given one or more hypothetical assumptions.

International Sustainability Standards Board (ISSB) (908) A board formed with the merger of the Sustainability Accounting Standards Board and the International Federation of Accountants to issue criteria related to environmental, social, and governance disclosure by companies.

Limited assurance (901) A level of assurance that is less than the reasonable assurance obtained in an audit, but is at an acceptable level as the basis for the conclusion expressed in the accountant's review report. Limited assurance is also referred to as *negative assurance*.

Management's Discussion and Analysis (MD&A) (911) Management's discussion of the company's operating results, liquidity, and financial position that is required in the regular form filings with the SEC. CPAs may examine or review this information. However, if the information is reviewed, the report must be restricted as to its use.

Negative assurance (901) A statement that in essence indicates that based on the procedures performed, nothing came to the auditor's attention that caused the auditor to believe that the information did not meet the criteria. For example, in the context of reviewed nonpublic company financial statements, "we are unaware of any material modifications that should be made. . . ." The term has been largely replaced in the auditing standards by the term *limited assurance*, although it still exists in certain auditing standards (e.g., letters for underwriters, included in Chapter 19).

PrimePlus/ElderCare (909) Services to help older individuals maintain, for as long as possible, their lifestyle and financial independence. Currently, while CPAs do provide such services, this exact term is infrequently used.

Responsible party (897) The party(ies) responsible (accountable) for the subject matter.

Review (901) An engagement designed to provide only a limited (moderate) degree of assurance about the conformance of subject matter, or an assertion about subject matter, with suitable criteria.

Service auditor (904) A practitioner who reports on controls at a service organization. SOC 1, 2, and 3 engagements all involve service auditors.

SOC 1 report (904) A service organization report intended to meet the needs of entities that use a service organization (user entities) and the CPAs that audit the user entity's financial statements (user auditors), in evaluating the effect of the controls at the service organization on the user entities' financial statements. The report addresses the service organization's internal control over financial reporting for a particular system. A Type 1 report is issued if the service auditor has not addressed the operating effectiveness of internal control and a Type 2 report is issued when operating effectiveness is addressed. The use of these reports is restricted to the management of the service organization, user entities, and user auditors.

SOC 2 report (905) A service organization report intended to meet the needs of a broad range of users that need detailed information and assurance about the controls at a service organization relating to one or more of the AICPA trust Services criteria of security, availability, processing integrity, confidentiality, and privacy. As with SOC 1 reports, a Type 1 report is issued if the service auditor has not addressed the operating effectiveness of internal control and a Type 2 report is issued when operating effectiveness is addressed. The use of these reports is restricted to the management of the service organization, customers of the service organization, and other stakeholders.

SOC 3 report (905) A service auditor report based on a SOC 2-type engagement addressing one or more of the AICPA trust services criteria of security, availability, processing integrity, confidentiality, or privacy. The reports issued differ from SOC 2 reports in that they are less detailed and are designed for general use and distribution. Only Type 2 reports may be issued.

Subject matter (896) The underlying topic of the engagement. For example, subject matter may be prospective financial information or internal control.

Suitable criteria (894, 908) Criteria that are objective and permit reasonably consistent measurement. Suitable criteria have the following characteristics: relevance, objectivity, measurability, completeness.

SysTrust (904) A Trust Service developed by the AICPA and CICA to provide assurance about the reliability of systems other than electronic commerce systems.

Trust services (902) A set of professional attestation and advisory services based on a core set of criteria related to security, availability, processing integrity, confidentiality, or privacy. These criteria are used when evaluating the suitability of the design and operating effectiveness of controls at an entity, division or operating unit level of an entity. A trust services engagement addresses one or more of the criteria. The current criteria were issued in 2017 and updated in 2020. Previous guidance used the term “principles and criteria.”

Type 1 report (904) A service organization report on (1) the fairness of the presentation of management’s description of the service organization’s system and (2) the suitability of the design. This type of report may not be issued for a SOC 1 engagement. PCAOB AS 2601 refers to such a report as a “report on controls placed in operation.”

Type 2 report (904) A service organization report on (1) the fairness of the presentation of management’s description of the service organization’s system, (2) the suitability of the design, and (3) the operating effectiveness of the controls to achieve the related control objectives included in the description throughout a specified period. PCAOB AS 2601 refers to this type of report as a “report on controls placed in operation and tests of operating effectiveness.”

WebTrust (904) A Trust Service developed by the AICPA and CICA to provide assurance on electronic commerce systems. This service is not generally available at this point.

XBRL (eXtensible Business Reporting Language) (909) An international information format designed specifically for business information. It assigns all individual disclosure items within business reports unique electronically readable tags that are mapped to taxonomies. The AICPA is in the process of developing guidance that will assist CPAs in public practice who are requested to provide assurance on XBRL-related documents.

Review Questions

- 20–1. Explain the relationship between assurance services and attestation services.
- 20–2. Comment on the correctness of the following statement: Because all attestation services are assurance services, all assurance services are also attestation services.
- 20–3. Describe the forces that have fueled the demand for assurance services.
- 20–4. A CPA’s report includes the following: “We are not aware of any material modifications that should be made in order for the information to be in conformity with accounting principles generally accepted in the United States of America, and accordingly, in our opinion, the financial statements follow those principles.”¹² Discuss the propriety of this portion of the report.
- 20–5. List and describe the three types of attestation engagements.
- 20–6. Distinguish between forms of attestation engagements that result in reports that are designed for “general use” and those that result in reports that are designed for “restricted use.”
- 20–7. Distinguish between an attestation engagement in which the practitioners report directly on the subject matter and one in which the practitioners report on an assertion about the subject matter.
- 20–8. What are “suitable criteria” and how do they relate to an attestation engagement?
- 20–9. Explain what is meant by *attestation risk*. What are its components?
- 20–10. Comment on the accuracy of the following: A client’s uncorrected material departure from the suitable criteria identified during an examination conducted under the attest standards is treated as a departure from GAAP in a financial statement audit—either a qualified or adverse opinion is appropriate.

¹² Ray Whittington and Kurt Pany, *Principles of Auditing and Other Assurance Services* (New York: Irwin/McGraw-Hill, 2001).

- 20–11. What is XBRL? How do assurance services relate to it?
- 20–12. “A company would normally include a financial projection in its annual report rather than a financial forecast.” Comment on the validity of this statement.
- 20–13. Comment on the following statement: A financial projection presents an organization’s expected results, given a hypothetical assumption.
- 20–14. Describe the two types of compliance services that may be performed under AICPA AT Section 601.
- 20–15. Identify the circumstances under which CPAs may examine Management’s Discussion and Analysis.
- 20–16. Describe the objectives of the practitioners’ examination of Management’s Discussion and Analysis.
- 20–17. List the categories of criteria that may be included in a trust services engagement.
- 20–18. What two types of cybersecurity examinations are available?
- 20–19. An auditor’s client uses the services of a payroll service provider. Which type of service auditor’s report is most likely to be helpful to that auditor: SOC 1, SOC 2, or SOC 3? Explain why.
- 20–20. Describe the primary purpose and intended users of each of the three types of service auditor reports presented in the Professional Standards.
- 20–21. The attestation standards provide guidance on agreed-upon procedures, review, and examination engagements. Which of these types of engagements are available for engagements using the trust services criteria?
- 20–22. What types of elder care services do CPAs typically perform?
- 20–23. Identify two types of assurance services that are currently under development by the AICPA.

Questions Requiring Analysis

Select questions are available with Connect.



LO 20-1

- 20–24. Other types of assurance services provided by CPAs have developed as a natural extension of the audit function.
 - a. Explain what is meant by the term *assurance services*.
 - b. Describe the forces that have caused a demand for other types of assurance services.
 - c. Describe the subset of assurance services governed by the *Statements of Standards for Attestation Engagements*.

LO 20-3

- 20–25. The nonpublic company attestation standards provide guidance for three basic types of engagements.
 - a. Describe these three types of engagements.
 - b. Describe the types of procedures performed for each of these three types of engagements.
 - c. Discuss the degree of assurance provided by each type of engagement.
 - d. Identify when each of the three types of engagements results in reports that are appropriate for *general use*.

LO 20-4

- 20–26. The management of Williams Co. is considering issuing corporate debentures. To enhance the marketability of the bond issue, management has decided to include a financial forecast in the prospectus. Management has requested that your CPA firm examine the financial forecast to add credibility to the prospective information.
 - a. Explain what is involved in an examination of a financial forecast.
 - b. Discuss the elements of a report on the examination of a financial forecast. (Do not write a report.)

LO 20-6

- 20–27. The accounting profession has developed trust services to help entities differentiate themselves by demonstrating that they are attuned to the risks posed by their environment and that they are equipped with controls that address those risks. Present the categories of criteria on which a trust services engagement may be based.

LO 20-2

- 20–28. In an engagement following the attestation standards, the subject matter must be capable of reasonably consistent evaluation against criteria that are suitable and available to the user.
 - a. Explain why criteria are needed for an attestation engagement.
 - b. Describe what makes a particular set of criteria *suitable* for an attestation engagement.
 - c. Explain how criteria are made *available* to users of the information.

Objective Questions

LO 20-2

20–29. Multiple Choice Questions

Select the best answer for each of the following and explain fully the reason for your selection.

LO 20-4

LO 20-6

LO 20-4

LO 20-6

LO 20-6

LO 20-6

LO 20-6

- a. A report on an attestation engagement should:
 - (1) State the nature of the client's control system.
 - (2) State the practitioner's conclusion about the subject matter or assertion.
 - (3) Include a Reasonable Limitations section pertaining to data inputs.
 - (4) Refer to the auditor's assertion concerning the subject matter.
- b. When an accountant examines a financial forecast that fails to disclose several significant assumptions used to prepare the forecast, the accountant should describe the assumptions in the accountant's report and issue a(n):
 - (1) Qualified opinion.
 - (2) Unqualified opinion with a separate explanatory paragraph.
 - (3) Disclaimer of opinion.
 - (4) Adverse opinion.
- c. Which of the following AICPA sets of standards (criteria) are *least* likely to be used in an examination engagement of a client's supply chain?
 - (1) Description criteria for supply chain engagements.
 - (2) Attestation standards.
 - (3) Generally accepted auditing standards.
 - (4) Trust services criteria.
- d. A CPA's examination report relating to a trust services engagement is most likely to include:
 - (1) An opinion on whether the system is electronically secure.
 - (2) An opinion on management's assertion that the system meets one or more of the trust services criteria.
 - (3) Negative assurance on whether the system is secure.
 - (4) No opinion or other assurance, but a summary of findings relating to the system.
- e. When performing an examination, if a CPA finds one or more significant assumptions are not reasonable for a forecast, the most appropriate report is:
 - (1) Adverse.
 - (3) Disclaimer.
 - (3) Qualified.
 - (4) Unqualified with emphasis-of-matter paragraph.
- f. Which of the following is least likely to be included in a direct examination engagement?
 - (1) Criteria.
 - (2) Report by the CPA.
 - (3) Object language.
 - (4) XBRL.
- g. Elder care services performed by CPAs may be:

	Financial	Nonfinancial
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

- h. When reporting on a company's compliance with a law, the CPAs may report on:

	Compliance with the Law Itself	Effectiveness of Internal Control over Compliance
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

- LO 20-1** i. Benchmarks that are objective and permit reasonably consistent measurement in an engagement performed under *Statements on Standards for Attestation Services* are referred to as:
- (1) Written assertions.
 - (2) Suitable criteria.
 - (3) Subject matter.
 - (4) Generally accepted auditing standards.
- LO 20-2** j. Which of the following is *least* likely to be the subject matter of an attestation engagement?
- (1) Behavior.
 - (2) Historical events.
 - (3) Suitable criteria.
 - (4) Systems or processes.
- LO 20-5** k. A restricted-use report on controls at a service organization related to security, availability, processing integrity, confidentiality, and/or privacy is referred to as a:
- (1) SOC 1 report.
 - (2) SOC 2 report.
 - (3) SOC 3 report.
 - (4) SOC 4 report.
- LO 20-4** l. The assurance services that address user and preparer needs regarding issues of security, availability, processing integrity, confidentiality, and privacy within electronic systems are referred to as:
- (1) *PrimePlus* services.
 - (2) XBRL services.
 - (3) Risk advisory services.
 - (4) Trust services.
- LO 20-4, 5, 6** 20–30. Following are descriptions of potential needs of clients for various services. For each need, identify the type of service that would best meet the client’s need using the following:
- Attestation of prospective financial information
 - Elder care services
 - Attestation of MD&A
 - Agreed-upon procedures
 - SOC 1
 - SOC 2
 - SOC 3
 - XBRL engagement
 - Other attestation service

Client Need	Type of Service
a. A computer manufacturing company wants to provide assurance about estimated future results to be included in the company’s annual report.	
b. A company that processes payroll for other companies wants to provide assurance on its internal control over financial reporting that will be useful to the auditors of the companies that use its services.	
c. A public company wants to provide its shareholders assurance about the narrative analysis of financial results provided in the company’s Form 10-K.	
d. A service organization wishes to provide a general-use report from its auditor on its processing integrity and confidentiality controls.	
e. The relative of an institutionalized uncle wants a CPA firm to oversee the uncle’s financial affairs.	

Client Need	Type of Service
f. A bank wants a CPA firm to confirm accounts receivable of a company that has pledged the receivables as collateral for a loan.	
g. A service organization wishes to provide a restricted-use report from its auditor to regulators on its processing integrity and confidentiality controls.	
h. A grocery store wants to provide the highest level of assurance that its prices are less than the prices of its competitors.	

LO 20-2, 3, 4, 5, 6 20–31. Indicate whether a CPA may provide each of the following services, and whether independence is required, by placing a check in the appropriate box.

Service	May Provide; Independence Is Required	May Provide; Independence Is Not Required	May Not Provide
a. Compile a forecast for the coming year.			
b. Perform a review of a forecast the company has prepared for the coming year.			
c. Perform an examination of Management's Discussion and Analysis when they have not audited the year's financial statements.			
d. Issue a trust services examination report on the security against unauthorized access of a service organization's electronic processing system.			
e. Assist an elderly client with his estate planning.			

LO 20-5 20–32. Place an "X" in each box of the following table when the engagement (SOC 1, SOC 2, or SOC 3) includes or is consistent with the attribute. For example, if you believe that the Attestation Standards are followed for a SOC 1 report, place an X in that box; otherwise leave it blank.

Attribute	SOC 1	SOC 2	SOC 3
Standards: Attestation			
Standards: Trust services			
Standards: Internal control over financial reporting			
Appropriate when outsourcing of a function is involved			
CPA Procedures for Engagement: Primarily substantive procedures			
Report: Type 1 appropriate			
Report: Type 2 appropriate			
Report: Restricted use			
Report: General use			
Report: Examination form is available			
Available for service organizations			
Report: May address operating effectiveness			

- LO 20-4, 5, 6** 20–33. For each of the situations (a) through (e), select the CPA engagement that is most likely to be appropriate from the list of services below:
- A. Compliance
 - B. Continuous auditing
 - C. Forecast
 - D. Service organization audit
 - E. MD&A
 - F. Elder care services
- Each reply may be used once or more than once, with some replies not being used.

Situation	CPA Engagement
a. Williams is worried about the welfare of his father, who lives in a distant state.	
b. ABC Company is involved in a very vibrant industry. It would like all of its press releases to include updated-to-the-moment audited results, regardless of when they are issued.	
c. DEF Mortgage Banking Co. services mortgages for others, and the auditors of those other organizations are constantly inquiring of DEF concerning its internal control as a part of their audits of the other organizations.	
d. JKL, a company that processes payrolls for other companies, would like all of its customers and potential customers to have assurance about the effectiveness of its internal control related to processing information.	
e. MNO Company believes that it has effective internal control to assure itself that it complies with various legal requirements, but it would like assurance from its CPA on compliance with the legal requirements.	

- LO 20-4, 5, 6** 20–34. Match the following definitions (or partial definitions) to the appropriate term. Each term may be used once or not at all.

Definition (or Partial Definition)	Term
a. A level of assurance related to an attestation examination engagement.	1. CBIZ
b. An international information format designed specifically for business information.	2. Direct examination
c. Engagements that provide assurance on systems' (a) security, (b) availability, (c) processing integrity, (d) online privacy, and (e) confidentiality.	3. Elder care services
d. Prospective financial statements that present an entity's expected financial position, results of operations, and cash flows for one or more future periods.	4. Financial forecast
e. Prospective financial statements that present expected results, given one or more hypothetical assumptions.	5. Financial projection
f. Services to help older individuals maintain, for as long as possible, their lifestyle and financial independence.	6. ISSB
g. The level of assurance provided by CPAs who have performed a review of subject matter.	7. Limited assurance
h. CPA measures or evaluates the underlying subject matter against the criteria and provides an opinion in the report.	8. Reasonable assurance
	9. Review
	10. Service auditor report
	11. Social Security services
	12. Sustainability services
	13. Trust services
	14. XBRL

Problems

LO 20-4

- 20–35. Trust services were developed by the AICPA and the CICA.

- a. Present and describe the criteria related to trust services.
- b. Must a trust services engagement include reporting on all the categories of criteria?

LO 20-2, 3, 4

- 20–36. Assume that you are a partner with the firm of Slater & Lowe LLP. You have been asked by Grayson Inc., an industrial supply company, to provide assurance about the change in existing

customer satisfaction over the last three years. Grayson's management has indicated that the criteria it intends to use to evaluate customer satisfaction are a combination of customer retention rate and increase in dollar sales. Grayson's management will provide a schedule of the customer satisfaction measures and a note that describes the criteria used.

- a. If Grayson wants to provide the presentation and the CPA's report for general use by prospective customers, identify any available standards that provide guidance for such a service and the type or types of services that your firm could provide.
- b. Describe the factors that you should consider in determining whether the criteria are suitable.

In-Class Team Case

LO 20-3, 6



20–37. Katherine Whipple of Food Queen Grocery Inc. has asked you and your team to meet with her concerning a possible attestation engagement relating to the assertion that Food Queen has the lowest overall prices of all grocery stores in the Salt Lake City area. Food Queen has just recently moved into the Salt Lake City area and is trying to establish a high-volume, profitable position. Whipple has suggested to you that she believes that while Food Queen certainly doesn't have the lowest prices on all of the 25,000 types of items it sells, on almost any rational basis she believes that its prices are "on the whole" lower than those of the competition—Albros, Kruegers, and Safest. In thinking about this, you realize that to perform such an attestation engagement, suitable criteria must be used to evaluate the subject matter.

- a. For this engagement, what would you consider to be the subject matter?
- b. Provide an approach on how one might derive suitable criteria for such an engagement, given that costs are considered lowest on an overall basis, but not necessarily for every item.
- c. Discuss the nature of the required assertion from management for an engagement such as this.

Now consider the following: Whipple has suggested to you that when the engagement is complete, she will use the results as part of an advertising campaign in which the ads suggest that Food Queen has the "certified lowest overall costs." When you asked her what would happen if the engagement revealed that Food Queen didn't have the lowest prices, she suggested that she would simply not use the report and wait a month or two and have you perform another engagement when she had time to bring her prices down even lower.

- d. Are attestation engagements acceptable when the resulting report is to be used for advertising purposes?

Research and Discussion Case

LO 20-5



20–38 **NOTE:** This case requires the availability of AICPA AT Section 320 of the professional attestation standards. AICPA professional standards are available on a subscription basis. Many universities have such subscriptions.

Assume that you are working for a firm that is beginning to perform System and Organization Controls (SOC) engagements. Several practice issues have arisen for which you have been asked to find answers in the professional standards. Go to Attestation Standard titled *Reporting on an Examination of Controls at a Service Organization Relevant to a User Entities' Internal Control Over Financial Reporting* (AT-C Section 320) to answer the following inquiries with quotes from the standard.

- a. A client has requested that the firm reduce the scope of the engagement. Is this allowable?
- b. On one of the engagements, the firm has decided to disclaim an opinion but wants to include the results of certain tests performed. Is this allowable?
- c. The firm is considering accepting an engagement, but it is not independent of all of the entities using the services of the service organization. Is this a problem?

Internal, Operational, and Compliance Auditing

To this point in the text, we have focused primarily on audits and other types of assurance services provided by independent public accountants. This chapter describes several additional types of auditing: internal, operational, and compliance auditing.

Internal Auditing

LO 21-1

Describe the functions performed by internal auditors.

Virtually every large corporation in the United States today maintains an internal auditing staff. This staff function has primarily developed since 1940, as few organizations had internal auditing departments prior to that point. In 1941, **The Institute of Internal Auditors (IIA)** was founded with only 24 members. Now the IIA is a worldwide organization with over 210,000 members and with local chapters in principal cities throughout much of the world. The growth of the IIA has paralleled the recognition of internal auditing as an essential control function in all types of organizations.

What Is the Purpose of Internal Auditing?

The Institute of Internal Auditors (IIA) defines **internal auditing** as

An independent, objective assurance and consulting activity designed to add value and improve an organization's operations.

It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.¹

Consistent with the definition, the IIA states that the **mission of internal audit** is to enhance and protect organizational value by providing risk-based and objective assurance, advice, and insight. In providing these functions, internal auditors can be thought of as a part of the organization's internal control. They represent a high-level control that functions by measuring and evaluating the effectiveness of other controls. As discussed in Chapter 7, AICPA generally accepted auditing standards include the internal auditing function as part of the "monitoring component" of an organization's internal control.

Internal auditors are not merely concerned with the organization's financial controls. Their work encompasses all of the organization's internal control. They evaluate and test the effectiveness of controls designed to help the organization meet all its objectives. Also, many internal auditing departments provide a wide range of other assurance and consulting services to the management of their organizations.

Evolution of Internal Auditing

Internal auditing has evolved to meet the needs of business and governmental and nonprofit organizations. Originally, a demand for internal auditing arose when managers of early large corporations recognized that annual audits of financial

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- LO 21-1** Describe the functions performed by internal auditors.
- LO 21-2** Describe the internal auditors' role with respect to the Sarbanes-Oxley Act.
- LO 21-3** Identify the standards for the professional practice of internal auditing.
- LO 21-4** Explain the nature and the purpose of an operational audit.
- LO 21-5** Distinguish among the various types of compliance audits.
- LO 21-6** Describe the auditing and reporting requirements of *Government Auditing Standards* and the Single Audit Act.

¹ The Institute of Internal Auditing as a part of its revision of the Global Standards for Internal Auditing is in the process of revising this definition.

statements by CPAs were not sufficient. A need existed for timely employee involvement beyond that of the certified public accountants to ensure accurate and timely financial records and to prevent fraud. These original internal auditors focused their efforts on financial and accounting matters.

Subsequently, the role of internal auditors expanded as a result of demands by the major stock exchanges and the Securities and Exchange Commission (SEC) that management accept more responsibility for the reliability of published financial statements. These demands resulted in expanded internal auditor responsibilities, including more detailed analysis of internal control, as well as testing of interim and other accounting information not considered in annual audits performed by certified public accountants.

Gradually, the role of internal auditors expanded to encompass overall operational policies and procedures. Companies in the defense industry were among the first to demand such services. These companies recognized the need for reliable operating reports because they were used extensively by management to make decisions. The reports often were expressed not in dollars but in terms of operating factors, such as quantities of parts in short supply, adherence to schedules, and quality of the product. Work by the internal auditors devoted to ensuring the dependability of these operating reports was effort better spent than additional audit effort devoted to financial and accounting matters.

As organizations became larger and more complex, they encountered additional operational problems that could be addressed by internal auditing. The internal auditors' role of determining whether operating units in the organization follow authorized accounting and financial policies was readily extended to include the determination of whether they follow all the organization's operating policies, and whether the established policies provide sound and effective control over all operations. The extension of internal auditing into these operational activities required internal auditors with specialized knowledge in other disciplines such as economics, law, finance, statistics, computer processing, engineering, and taxation.

Several events have been important to the evolution of the internal auditing profession. The first was the enactment of the Foreign Corrupt Practices Act of 1977. The accounting provisions of that act require public companies to establish and maintain effective internal accounting control. To ensure compliance with these provisions, many companies established or augmented their internal auditing departments.

Another event that affected the internal auditing profession was the issuance in 1987 of the *Report of the National Commission on Fraudulent Financial Reporting*. This report contains the commission's findings and recommendations about preventing fraudulent financial reporting by public companies. Among its recommendations was a suggestion that public companies establish an internal auditing function staffed with appropriately qualified personnel and fully supported by top management. The commission also recommended that the companies help ensure the internal auditing function's objectivity by positioning it suitably within the organization, maintaining a director of the internal auditing function with appropriate stature, and establishing effective reporting relationships between the director of internal auditing and the audit committee of the board of directors. Consistently, in 1999 the *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* concluded that appropriate responsibility for the oversight of financial integrity and accountability of public companies may be viewed as a three-legged stool consisting of (1) management and internal audit, (2) the board of directors and its audit committee, and (3) the external auditors.

The reengineering of companies in the mid-1990s led companies to *outsource* many of their noncore functions, including, in some cases, internal auditing. When these functions are outsourced, a specialized service provider other than company employees performs a portion or all of the internal auditing function. In some cases, CPA firms that also performed the audit of the financial statements provided major portions of the internal auditing function for companies. Providing both internal and external auditing services for SEC reporting clients has since been prohibited by the Sarbanes-Oxley Act of 2002.

Focus on Outsourcing the Internal Auditing Function

Prior to it being prohibited, CPA firm performance of all or a portion of the internal audit function for an audit client was extremely controversial. CPA firms argued that they could provide internal auditing services effectively and promised such benefits as lower costs and improved specialization, while allowing management to focus on core business issues. The AICPA positioned such services as “extended audit services” that were acceptable if the client understood its responsibility for establishing and maintaining internal control and directing the internal auditing function. Representatives of The Institute of Internal Auditors questioned the propriety of CPAs’ assuming responsibilities that are part of a corporation’s internal control when they also audit that company.

The Internal Auditors’ Role in Sarbanes-Oxley Compliance

LO 21-2

Describe the internal auditors’ role with respect to the Sarbanes-Oxley Act.

Internal auditors possess skills and experience that make them particularly valuable to a company’s compliance efforts related to the Sarbanes-Oxley Act. As a result, many companies have involved their internal audit departments in documenting and testing controls to support management’s assertion about the effectiveness of internal control over financial reporting. However, it is important to remember that it is management’s responsibility to ensure the organization is in compliance with the requirements of the Sarbanes-Oxley Act. The internal auditors’ role in documenting and testing controls can be significant, but it must be compatible with the overall mission and **charter** of the internal audit function, and it should not be seen as impairing the internal auditors’ objectivity.

The work of the internal auditors also may be used by the external auditors in fulfilling the external audit function. PCAOB auditing standards (PCAOB AS 2605) allow the external auditors to use certain work of the internal auditors in fulfilling their responsibilities to provide an opinion on internal control over financial reporting.

Professional Standards of Internal Auditing

To promote high-quality practice by internal auditors, the IIA has developed the International Professional Practice Framework, which consists of the following guidance:²

Mandatory Guidance

- Core Principles for the Professional Practice of Internal Auditing
- Definition of Internal Auditing
- Code of Ethics
- International Standards for the Professional Practice of Internal Auditing

Recommended Guidance

- Implementation Guidance
- Supplemental Guidance

Most relevant to the performance of internal audit services are the *International Standards for the Professional Practice of Internal Auditing*. The purposes, titles, and overall structure of these standards are presented in Figure 21.1. The detailed standards and interpretations are included in Appendix 21A.

LO 21-3

Identify the standards for the professional practice of internal auditing.

As illustrated in Figure 21.1, the IIA standards are divided into two categories: attribute standards and performance standards. In the following sections we recap those standards. The IIA is in the process of revising its professional and ethical standards into a set of integrated Global Internal Audit Standards. The new standards are expected to be effective at the end of 2024.

² The Institute of Internal Auditors is in the process of revising its professional standards. The new Global Internal Audit standards include Standards on Ethics and Professionalism, Governing the Internal Audit Function, Managing the Internal Audit Function, and Performing Internal Audit Services. The new standards are expected to be effective at the end of 2024.

FIGURE 21.1 IIA International Standards (Titles) for the Practice of Internal Auditing**The purpose of the *Standards* is to:**

1. Guide adherence with the mandatory elements of the International Professional Practices Framework.
2. Provide a framework for performing and promoting a broad range of value-added internal auditing services.
3. Establish the basis for the evaluation of internal audit performance.
4. Foster improved organizational processes and operations.

Attribute Standards**1000 – Purpose, Authority, and Responsibility**

1010 – Recognizing Mandatory Guidance in the Internal Audit Charter

1100 – Independence and Objectivity

1110 – Organizational Independence

1111 – Direct Interaction with the Board

1112 – Chief Audit Executive Roles Beyond Internal Auditing

1120 – Individual Objectivity

1130 – Impairment to Independence or Objectivity

1200 – Proficiency and Due Professional Care

1210 – Proficiency

1220 – Due Professional Care

1230 – Continuing Professional Development

1300 – Quality Assurance and Improvement Program

1310 – Requirements of the Quality Assurance and Improvement Program

1311 – Internal Assessments

1312 – External Assessments

1320 – Reporting on the Quality Assurance and Improvement Program

1321 – Use of “Conforms with the *International Standards for the Professional Practice of Internal Auditing*”

1322 – Disclosure of Nonconformance

Performance Standards**2000 – Managing the Internal Audit Activity**

2010 – Planning

2020 – Communication and Approval

2030 – Resource Management

2040 – Policies and Procedures

2050 – Coordination and Reliance

2060 – Reporting to Senior Management and the Board

2070 – External Service Provider and Organizational Responsibility for Internal Auditing

2100 – Nature of Work

2110 – Governance

2120 – Risk Management

2130 – Control

2200 – Engagement Planning

2201 – Planning Considerations

2210 – Engagement Objectives

2220 – Engagement Scope

2230 – Engagement Resource Allocation

2240 – Engagement Work Program

2300 – Performing the Engagement

2310 – Identifying Information

2320 – Analysis and Evaluation

2330 – Documenting Information

2340 – Engagement Supervision

2400 – Communicating Results

2410 – Criteria for Communicating

2420 – Quality of Communications

2421 – Errors and Omissions

2430 – Use of “Conducted in Conformance with the *International Standards for the Professional Practice of Internal Auditing*”

2431 – Engagement Disclosure of Nonconformance

2440 – Disseminating Results

2450 – Overall Opinions

2500 – Monitoring Progress**2600 – Communicating the Acceptance of Risks**

Attribute Standards

The four attribute standards address (1) purpose, authority, and responsibility; (2) independence and objectivity; (3) proficiency and due professional care; and (4) quality assurance and improvement program.

Purpose, Authority, and Responsibility The purpose, authority, and responsibility of the internal auditing department should be set forth in the department's charter, as approved by the organization's board of directors. Its purpose should be consistent with the IIA's mission of internal auditing, the Code of Ethics, the *Standards*, and the definition of internal auditing.

Independence and Objectivity Because internal auditors are employees of the organization, they are unlikely to have the perceived independence of external auditors. However, independence is still very important to internal auditors. They should maintain an impartial, objective attitude and avoid conditions that threaten the ability to carry out work in an unbiased manner. Independence of the internal auditing department is enhanced when the **chief audit executive**³ reports to a level within the organization that allows the internal audit activity to fulfill its responsibilities. Ideally, the chief audit executive should report directly to the audit committee of the board of directors. Independence is also enhanced when potential conflicts of interest are considered in assigning staff to audit assignments. For example, it would be a conflict of interest for an internal auditor to audit an area in which that individual was recently employed. It is difficult, if not impossible, to remain objective in evaluating one's own operating decisions.

Proficiency and Due Professional Care An internal auditing department should establish policies and procedures that ensure that staff members are competent to fulfill their assignments with professional proficiency. Ideally, the internal auditing department collectively should possess the skills and knowledge necessary to fulfill all the audit requirements of the organization. These skills and knowledge may be acquired through a combination of effective employment practices and a commitment to continuing professional development.

Internal auditors must apply due care in performing their work by considering factors that are critical to performing an engagement, including complexity, controls, materiality, and the probability of misstatements. Due care involves considering the use of technology-based and other data analysis techniques and being alert to significant risks. In performing consulting engagements, internal auditors should consider the needs of the clients, complexity of the engagement, and the costs and benefits of the engagement.

Quality Assurance and Improvement Program The chief audit executive should establish a quality assurance and improvement program that covers all aspects of the internal audit activity and continuously monitors its effectiveness. The quality assurance and improvement program must include both internal and external assessments of effectiveness. Communications to senior management and the board of directors should include the (1) scope of assessments, (2) qualifications and independence of assessors, (3) conclusions, and (4) corrective action plans.

Performance Standards The performance standards address (1) managing the internal audit function, (2) nature of work, (3) engagement planning, (4) performing the engagement, (5) communicating results, (6) monitoring progress, and (7) communicating the acceptance of risks.

Managing the Internal Audit Activity This group of standards provides guidance for the chief audit executive in managing the internal auditing function. The chief audit executive is responsible for properly administering the department to help assure that (1) audit activity is planned based on a risk assessment; (2) plans are approved by senior management and the board; (3) audit work is planned, controlled, and coordinated to ensure that maximum value is provided to the organization; and (4) the resources of the internal auditing department are efficiently and effectively employed.

Nature of Work The internal auditing department must evaluate and contribute to improving the organization's governance, risk management, and control processes through using a systematic, disciplined, and risk-based approach.

³ This title, used by the IIA, is equivalent to the director of internal auditing.

Engagement Planning The IIA's standards in this category recognize that if audit work is to be effective, it must be adequately planned. Effective planning includes developing appropriate objectives, scope, timing, and resource allocations.

Performing the Engagement In performing every engagement, the internal auditors should identify relevant information, perform appropriate analysis and evaluation of the information, prepare work papers that support their conclusions, and adequately supervise staff members assigned to the engagement.

Communicating Results For audit work to have its intended effect, the results must be communicated to appropriate individuals accurately, objectively, completely, constructively, clearly, concisely, and on a timely basis. Communications should include the engagement's objectives as well as applicable conclusions and recommendations. When applicable, reports should indicate that the engagement was conducted in accordance with the IIA standards.

Monitoring Progress This aspect of auditing standards involves monitoring the progress of the organization with respect to the internal auditors' recommendations. The chief audit executive should follow up to determine that management has taken appropriate action on recommendations, or that management has decided to accept the risk of not taking any action.

Communicating the Acceptance of Risks When the chief audit executive believes that management has accepted a level of risk that may be unacceptable to the organization, the matter should be discussed with senior management. If the matter remains unresolved, the chief audit executive must communicate the matter to the board of directors.

Certification of Internal Auditors

Since 1974, the IIA has administered the **Certified Internal Auditor (CIA)** program. To become certified, a candidate must hold a bachelor's degree from an accredited college and successfully complete a three-part examination that is offered throughout the world. The three parts of the examination include Essentials of Internal Auditing, Practice of Internal Auditing, and Business Knowledge for Internal Auditing. Another requirement of certification is at least two years of work experience in internal auditing or its equivalent, although an advanced academic degree may be substituted for one year of work experience in meeting this requirement. When internal auditors become certified, they must meet requirements for continuing professional education. More information on internal auditing and the CIA examination is available at www.theiia.org.

Operational Auditing

LO 21-4

Explain the nature and the purpose of an operational audit.

The term **operational auditing** refers to comprehensive examination of an operating unit or a complete organization to evaluate its systems, controls, and performance, as measured by management's objectives. Whereas a *financial audit* focuses on the measurement of financial position, results of operations, and cash flows of an entity, an operational audit focuses on the *efficiency*, *effectiveness*, and *economy* of operations. The operational auditor appraises management's operating controls and systems over such varied activities as purchasing, data processing, receiving, shipping, office services, advertising, and engineering.

Objectives of Operational Audits

Operational audits are often performed by internal auditors for their organizations. The major users of operational audit reports are managers at various levels, including the board of directors. Top management needs assurance that every component of an organization is working to attain the organization's goals. For example, management needs the following:

1. Assessments of the unit's performance in relation to management's objectives or other appropriate criteria.
2. Assurance that its plans (as set forth in statements of objectives, programs, budgets, and directives) are comprehensive, consistent, and understood at the operating levels.
3. Objective information on how well its plans and policies are being carried out in all areas of operations, as well as information on opportunities for improvement in effectiveness, efficiency, and economy.

4. Information on weaknesses in operating controls, particularly as to possible sources of waste.
5. Reassurance that all operating reports can be relied on as a basis for action.

Governmental auditors, such as those employed by the Government Accountability Office (GAO), perform operational audits of governmental programs that are administered by both governmental and nongovernmental organizations. Operational auditing is especially applicable to governmental programs where the effectiveness of the programs cannot be evaluated in terms of profits; they must be evaluated by measuring such elements as the number of families relocated, the number of individuals rehabilitated, and the extent of the improvement in environmental conditions. In addition to internal and governmental auditors, CPA firms perform operational audits for clients through their consulting services departments.

General Approach to Operational Audits

In many respects, the auditor's work in performing an operational audit is similar to that of a financial statement audit, but there are some significant differences. The steps may be set forth as (1) definition of purpose, (2) familiarization, (3) preliminary survey, (4) program development, (5) fieldwork, (6) reporting the findings, and (7) follow-up. The operational audit process is illustrated in Figure 21.2.

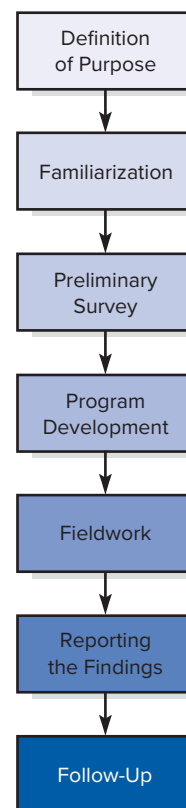
Definition of Purpose

The broad statement of purpose of an operational audit usually includes the intention to appraise the performance of a particular organization, function, or group of activities. However, this broad statement must be expanded to specify precisely the scope of the audit and the nature of the report. The auditors must determine specifically which policies and procedures are to be appraised and how they relate to the specific objectives of the organization.

Familiarization

Before starting an operational audit, the auditors must obtain a comprehensive knowledge of the objectives, organizational structure, and operating characteristics of the unit being audited. This familiarization process might begin with a study of organizational charts,

FIGURE 21.2
The Operational Audit



statements of the functions and responsibilities assigned, management policies and directives, and operating policies and procedures. At this stage, the auditors may read some of the published material available on the subject to acquaint themselves as fully as possible with the functions performed. This background information equips the auditor to visit the organization's facilities and interview supervisory personnel to determine their specific objectives, the standards used to measure accomplishment of those objectives, and the principal problems encountered in achieving those objectives. During these visits, the auditors also will observe the operations and inspect the available records and reports.

In summary, the auditors attempt to familiarize themselves as thoroughly as possible with the function being performed, particularly from the standpoint of administrative responsibility and control. The auditors' understanding of the organization is documented with questionnaires, flowcharts, and written narratives.

Preliminary Survey

The auditors' preliminary conclusions about the critical aspects of the operations and potential problem areas are summarized as the auditors' preliminary survey. This survey serves as a guide for the development of the audit program.

Program Development

The operational audit program is tailor-made to the particular engagement. It contains all the tests and analyses the auditors believe are necessary to evaluate the organization's operations. Based on the nature and difficulty of the audit work, appropriate personnel will be assigned to the engagement, and the work will be scheduled.

Fieldwork

The fieldwork phase involves executing the operational audit program. The auditors select the items to be reviewed to determine the adequacy of the procedures and how well they are followed. Just as in financial statement audits, the auditors will frequently select representative samples of the transactions from the records and inspect them to determine whether proper procedures have been followed and to discover the nature and extent of the problems encountered. In other cases, they may resort to inquiry or direct observation to satisfy themselves that the employees understand their instructions and are carrying out their work as intended.

Analysis is another important part of fieldwork. Actual performance by the organization is compared with various criteria, such as budgets, productivity goals, or performance by similar units. This analysis provides a basis for auditors' recommendations for improvements in effectiveness, efficiency, and economy.

As each phase of the fieldwork is completed, the auditors summarize the results and evaluate the material gathered. Deficiencies that appear to be significant are discussed with the supervisor involved. Frequently, corrective action may be taken at this time, although the primary purpose of this on-the-spot discussion is to make sure that all the relevant facts have been obtained.

During fieldwork, the auditors will document the planning, evidence gathered, analysis, interpretation, and findings in their *working papers*. The audit working papers should stand alone and support the auditors' report.

Reporting the Findings

On final completion of the fieldwork, the auditors should summarize their findings related to the basic purposes of the audit. The report will include suggested improvements in the operational policies and procedures of the unit and a list of situations in which compliance with existing policies and procedures is less than adequate. After they have completed the draft report, they should arrange an *exit conference* to review the findings with all persons directly concerned with the operations audited. The conference ensures that the auditors have an accurate and complete story; if there is a question about the facts, further investigation will be made until any doubt is resolved. If a serious disagreement on the interpretation of the facts remains, it is usually best to disclose both interpretations in the report. The conference also provides an opportunity for the affected management to consider and take timely action on the problems disclosed.

FIGURE 21.3
Introductory Language
for an Operational Audit
Report

October 2, 20X1

Neal McGregor
Vice President—Operations
Baxter Corporation
Kansas City, Missouri

Dear Mr. McGregor:

In September 20X1, we concluded an operational audit of the data processing operations.

Objectives, Scope, and Approach

The general objectives of this engagement, which were more specifically outlined in our letter dated June 30, 20X1, were as follows:

- To document, analyze, and report on the status of current operations.
- To identify areas that require attention.
- To make recommendations for corrective action or improvements.

Our operational audit encompassed the centralized data processing facilities and the on-site computer operations of the company's retailing division. Our evaluations included both the financial and operational conditions of the units. Financial data consulted in the course of our analyses were not audited or reviewed by us, and, accordingly, we do not express an opinion or any other form of assurance on them.

The operational audit involved interviews with management personnel and selected operations personnel in each of the units studied. We also evaluated selected documents, files, reports, systems, procedures, and policies as we considered appropriate. After analyzing the data, we developed recommendations to correct deficiencies and for improvements. We then discussed our findings and recommendations with appropriate unit management personnel, and with you, prior to submitting this written report.

Findings and Recommendations

All significant findings are included in this report for your consideration. The recommendations in this report represent, in our judgment, those most likely to bring about improvements in the operations of the organization. The recommendations differ in such aspects as difficulty of implementation, urgency, visibility of benefits, and required investment in facilities and equipment or additional personnel. The varying nature of the recommendations, their implementation costs, and their potential impact on operations should be considered in reaching your decision on courses of action.

(Specific Findings and Recommendations)

A formal report, such as the one illustrated by Figure 21.3, is then issued to top management. For each finding, a complete report will describe (1) the *criteria* used to evaluate the activity, (2) the *condition* (e.g., problem) that exists, (3) the *cause*, (4) the *effect*, and (5) *recommendations* for improvement (including any corrective actions already taken).

Follow-Up

The final stage in the operational auditors' work is the follow-up action to ensure that any deficiencies disclosed in the audit report are satisfactorily handled. This follow-up responsibility may be given to a line organization or staff group, but most frequently it is held to be a responsibility of the audit staff. In some instances, the auditors find it desirable to make brief reexaminations after a reasonable lapse of time to ensure that all significant recommendations have been implemented.

Compliance Auditing

LO 21-5

Distinguish among the various types of compliance audits.

Society has always been concerned about compliance with laws and regulations by all types of organizations. As a result, compliance auditing has evolved to become an important part of the work of both external and internal auditors. **Compliance auditing** involves testing and reporting on whether an organization has complied with the requirements of various laws, regulations, and agreements. Congress and various regulators have adopted

compliance auditing requirements for a wide variety of business, governmental, and non-profit organizations. The Auditing Standards Board has developed general guidelines for all types of engagements that involve attesting to compliance with laws and regulations, and more specific guidelines for compliance auditing of federal financial assistance programs.

	Illustrative Cases	Compliance Auditing: Two Examples
	COMPLIANCE WITH THE CLEAN AIR ACT The Environmental Protection Agency has issued guidelines for Oxygenated Gasoline Credit Programs under the Clean Air Act, which require CPAs (or internal auditors) to perform agreed-upon procedures regarding a company's compliance with an EPA regulation that requires gasoline to contain at least 2 percent oxygen. Management's assertion indicates the company's compliance with the relevant requirements (which are specifically listed) of the Clean Air Act.	COMPLIANCE WITH THE FDIC IMPROVEMENT ACT OF 1991 The Federal Depository Insurance Corporation (FDIC) Improvement Act of 1991 requires that CPAs be engaged to perform agreed-upon procedures engagements to test large financial institutions' compliance with certain provisions related to the "safety and soundness" of the institutions. The assertion in this case states management's belief that the institution has complied with the listed provisions of the act.

Attesting to Compliance with Laws and Regulations

AT-C 315 *Compliance Attestation* provides guidance for CPAs when they are engaged either to apply agreed-upon procedures or perform an examination on an organization's compliance with laws and regulations.⁴ The standard prohibits CPAs from performing *reviews* of compliance with laws and regulations.

In compliance attestation engagements, CPAs address an organization's **compliance with specified requirements**, or its internal control over compliance with specific laws and regulations. Management⁵ provides a written representation to the CPAs acknowledging its responsibility for (1) understanding and complying with compliance requirements and (2) the design, implementation, and maintenance of controls that provide reasonable assurance that the entity administers government programs in accordance with compliance requirements. The CPAs' report provides assurance either on **management's assertion** or directly on compliance.

Applying Agreed-Upon Procedures to Test Compliance with Specified Requirements

Engagements to apply agreed-upon procedures to test compliance with specified requirements are common compliance engagements. The objective of an agreed-upon procedures engagement is to assist users in evaluating an entity's compliance with specified requirements based on procedures agreed upon by the users of the report. A major advantage of agreed-upon procedures engagements results from the fact that because the users participate in designing the procedures to be performed by the CPAs, it is likely that the work performed will meet their needs.

Agreed-upon procedures reports are restricted-use reports, intended for the audit committee, management, and other parties for whom the procedures were designed (e.g., the Environmental Protection Agency). The reports provide a summary of procedures performed and the CPAs' findings. The findings section of the report should set forth any instances of **noncompliance** with relevant laws and regulations noted by the CPAs, regardless of whether they became aware of them as a result of the procedures performed or in some other way, such as through an informal discussion with an internal auditor.

⁴ In addition to AT-C 315, a practitioner should comply with AT-C 105 *Concepts Common to All Attestation Engagements*, AT-C 205 *Examination Engagements*, and AT-C 215 *Agreed-Upon Procedures Engagements*.

⁵ AT-C 105 provides that the report should identify the party responsible for the assertion or the subject matter of the assertion. The responsible party is the person or persons, as either individuals or representatives of the entity, responsible for the subject matter. Management is deemed to be the "responsible party" throughout this chapter.

The format of a report on the application of agreed-upon procedures to compliance is illustrated in the accompanying box.

Independent Accountant's Report

TO LENOS COMPANY:

We have performed the procedures enumerated below, which were agreed to by the Illinois Department of Education, solely to assist the users in evaluating Lenos Company's compliance with Section F.2 of Illinois Department of Education Regulation 74A of *Employment Health Requirements* during the period ended December 31, 20X1, included in the accompanying Management Report. Management is responsible for Lenos Company's compliance with these requirements. The sufficiency of these procedures is solely the responsibility of those parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

[Include paragraphs to enumerate procedures and findings.]

This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. We were not engaged to and did not conduct an examination, the objective of which would be the expression of an opinion on compliance. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the Illinois Department of Education and is not intended to be and should not be used by anyone other than these specified parties.

Applying Agreed-Upon Procedures to Test the Effectiveness of Controls over Compliance

As indicated previously, CPAs also may be engaged to test the effectiveness of the organization's internal control over compliance. An organization's **internal control over compliance** is the process by which management obtains reasonable assurance that the organization has complied with specific requirements. The CPAs' report on the application of agreed-upon procedures to test the effectiveness of controls over compliance is similar to the report on compliance that is presented below. It describes the tests of controls performed and the related findings and includes the appropriate limitations on the distribution of the report and other caveats.

Performing Examinations

CPAs are sometimes engaged to perform an examination of a client's compliance with specified requirements (the subject matter) or of management's assertion related thereto. In performing an examination engagement, the CPAs begin by obtaining a thorough understanding of the requirements. Then they plan the engagement, consider the organization's internal control over compliance, perform sufficient procedures to form an

Independent Accountant's Report

TO LENOS COMPANY:

We have examined Lenos Company's compliance with Section F.2 of Illinois Department of Education Regulation 74A of *Employment Health Requirements* during the period ended December 31, 20X1. Management is responsible for Lenos Company's compliance with those requirements. Our responsibility is to express an opinion on the Company's compliance based on our examination.

Our examination was conducted in accordance with standards established by the American Institute of Certified Public Accountants, and, accordingly, included examining, on a test basis, evidence about Lenos Company's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion. Our examination does not provide a legal determination on Lenos Company's compliance with specified requirements.

In our opinion, Lenos Company complied, in all material respects, with the aforementioned requirements for the year ended December 31, 20X1.

opinion on compliance (or on management's assertion about compliance), and issue an opinion on compliance with specified requirements. An unqualified opinion on compliance with laws and regulations is shown in the accompanying box.

The CPAs' examination report should be modified in the following circumstances:

- *Material noncompliance with specified requirements.* A qualified or adverse opinion should be issued when the auditors' procedures indicate that the organization did not comply with the requirements (reporting directly on the subject matter) or that management's report is not fairly stated.
- *Scope restriction.* A qualified opinion or disclaimer of opinion should be issued when the CPAs' procedures are restricted.
- *Involvement of another CPA firm in the examination.* In these circumstances, the principal CPA firm generally issues a report that indicates a division of responsibility.

Although the CPAs' examination report may generally be either on the subject matter or on management's assertion, when it is other than unqualified, the CPAs must report directly on the subject matter.

Compliance Reporting by Broker-Dealers under PCAOB Requirements

In 2013, the SEC adopted amendments to the Securities Exchange Act of 1934 ("Exchange Act")⁶ to implement a portion of the Dodd-Frank Wall Street Reform and Consumer Protection Act relating to brokers and dealers. The purpose was to strengthen and clarify **broker-dealer** annual financial reporting requirements and oversight of such information by CPAs. A broker-dealer is a person or firm in the business of buying and selling securities. Such a firm operates as a broker when it processes orders on behalf of clients and as a dealer when it trades for its own account.

While broker-dealers for many years have filed annual audited financial statements and various supplemental schedules with the SEC, the amendments to the Exchange Act require additional reporting on compliance. Essential to this reporting is the broker-dealer's internal control over compliance with various SEC requirements (referred to as financial responsibility rules, such as maintaining adequate controls to safeguard client securities). Each broker-dealer who maintains custody of customer funds or securities is required to file an annual compliance report on whether

1. The broker-dealer has established and maintained internal control over compliance.
2. Internal control over compliance was effective during the most recent fiscal year.
3. Internal control over compliance was effective as of the end of the most recent fiscal year.
4. The broker-dealer was in compliance with various related rules addressing areas including safeguarding customer securities and funds and maintaining necessary capital or reserves.
5. The information the broker-dealer used to assess compliance with point 4 was derived from its books and records.

A broker-dealer is required to engage a CPA to examine statements 2 through 5 and to issue a report based on that examination. PCAOB *Attestation Standard 1*, "Examination Engagements Regarding Compliance Reports of Brokers and Dealers," provides guidance for compliance audits. Both the broker-dealer's report and the auditor's compliance report describe identified material weaknesses in internal control over compliance and any noncompliance with a rule.

A broker-dealer that considers itself exempt from the requirements (ordinarily because that broker does not maintain custody of customer funds or securities) obtains an auditor's review report concerning the exemption. PCAOB *Attestation Standard 2*, "Review Engagements Regarding Exemption Reports of Brokers and Dealers," provides guidance for reviews.

⁶ The specific rules most directly involved with compliance reporting are 15 and 17. The 1934 Securities Exchange Act is available at www.sec.gov/about/laws/sea34.pdf.

Compliance Auditing of Government Entities and Organizations Receiving Federal Financial Assistance

LO 21-6

Describe the auditing and reporting requirements of *Government Auditing Standards* and the Single Audit Act.

AICPA AU-C 935 provides guidance on performing tests of compliance in the following types of audits:

- Audits of the financial statements of entities receiving federal financial assistance in accordance with AICPA generally accepted auditing standards.
- Audits conducted in accordance with *Government Auditing Standards*.
- Audits conducted in accordance with the federal Single Audit Act.⁷

Audits in Accordance with AICPA Generally Accepted Auditing Standards

As discussed in Chapter 2, auditors have a responsibility to design all audits to obtain reasonable assurance of detecting material misstatements resulting from violations of laws and regulations that have a *direct and material effect* on line-item amounts in the financial statements. Governmental organizations are subject to a variety of laws and regulations that affect their financial statements—many more than typical business enterprises. An important aspect of generally accepted accounting principles for governmental organizations is the recognition of various legal and contractual requirements. These requirements pertain to bases of accounting, fund structure, and other accounting principles. Therefore, in performing an audit of a governmental organization's financial statements, auditors are more likely to encounter laws and regulations that have a direct and material effect on the amounts in the organization's financial statements.

Governmental organizations receive funds from various sources, including taxes, special assessments, and bond issues. Laws and regulations often dictate the way the funds may be spent. While certain funds may be used for general government purposes, others are restricted to specific purposes, such as schools, libraries, or highways.

A governmental organization also may receive financial assistance from other governmental organizations in the form of grants, loans, loan guarantees, interest subsidies, insurance, and food commodities. This financial assistance often is provided subject to specified compliance requirements. For example, a federal agency may provide financial assistance to a governmental organization but require the organization to match the federal funding. In the event a governmental organization does not comply with the matching requirement, it may have to refund the federal financial assistance.

Auditors perform a number of procedures to identify the laws and regulations that have a direct effect on an organization's financial statements, including (1) discussing laws and regulations with management, program and grant administrators, and government auditors; (2) reviewing state and federal compliance requirement documents; (3) reviewing relevant grant and loan agreements; and (4) reviewing minutes of the legislative body of the governmental organization. Auditors also obtain written representations from management about the completeness of the laws and regulations identified and an acknowledgment of management's responsibility for compliance with them.

When auditors have an understanding of the important laws and regulations, they assess the risks that financial statement amounts might be materially affected by violations.⁸ In making these assessments, they consider the controls designed to prevent violations, such as policies regarding acceptable operating practices, codes of conduct, and assignment of responsibility for complying and assessing compliance with legal and regulatory requirements. These risk assessments are then used to design the nature, timing, and extent of the auditors' substantive tests of compliance.

⁷ AICPA AU-C 935 refers to the Single Audit Act of 1984. This act was amended in its entirety by the Single Audit Act Amendments of 1996.

⁸ Generally, laws and regulations concerning compliance with financial assistance programs do not discuss compliance in terms of whether or not noncompliance might materially misstate the financial statements. These laws and regulations discuss the effect of noncompliance in terms of whether it has a direct and material effect on financial assistance programs.

Audits in Accordance with Government Auditing Standards

The Government Accountability Office issues *Generally Accepted Government Auditing Standards* (GAGAS) for use in auditing federal entities and organizations that receive federal financial assistance. They include standards for financial audits and performance audits. These standards are included in a publication entitled **Government Auditing Standards**, which is commonly referred to as the “Yellow Book.” The standards apply only when required by law, regulation, or agreement. These standards impose additional requirements related to (1) ethics, independence, and professional judgment; (2) competence and continuing education; (3) quality control and peer review; (4) audit communication; (5) considering the results of previous audits; (6) noncompliance with provisions of contracts and grant agreements; (7) findings; (8) audit documentation; and (9) reporting.

Ethics, Independence, and Professional Judgment GAGAS place additional emphasis on ethical principles as the basis for the implementation of the standards, including a description of the following five key principles that should guide government audits:

1. *The public interest*—Observing integrity, objectivity, and independence in performing professional services assists the auditors in serving the public interest.
2. *Integrity*—Public confidence in government is maintained by auditors’ performing professional services with integrity.
3. *Objectivity*—Objectivity includes being independent in fact and appearance when providing audit and attest services, maintaining an attitude of impartiality, being intellectually honest, and being free from conflicts of interest.
4. *Proper use of government information, resources, and position*—These items should be used for official purposes and not for the auditors’ personal gain or otherwise inappropriately.
5. *Professional behavior*—Auditors should comply with laws and regulations and avoid any conduct that might bring discredit to the auditors’ work.

GAGAS include specific requirements for auditor independence and a conceptual framework for independence similar to the AICPA’s independence framework presented in Chapter 3. It includes examples of nonaudit services that would impair the independence of the CPA firm.

GAGAS also require auditors to use appropriate professional judgment. Professional judgment includes exercising reasonable care and professional skepticism in performing the engagement and reporting the results.

Competence and Continuing Education GAGAS require the audit firm to have a process for recruiting, hiring, continuous development, assignment, and evaluation of personnel so that auditors assigned to engagements have the essential knowledge, skills, and abilities necessary to conduct the engagements in accordance with GAGAS.

Auditors who are assigned to perform or report on an engagement conducted in accordance with GAGAS must complete at least 80 hours of CPE in every two-year period, with at least 24 hours being directly related to government entities or government auditing.

Quality Control and Peer Review GAGAS quality control requirements are very similar to those of the AICPA. The standards require audit firms to implement a quality control system that is designed to provide reasonable assurance that the firm and its personnel comply with professional standards and applicable legal and regulatory requirements.

The standards require CPA firms conducting engagements in accordance with GAGAS to obtain external peer reviews. The peer review should be sufficient in scope to provide a reasonable basis for determining whether (1) the reviewed audit organization’s system of quality control was suitably designed and (2) the organization is complying with its quality control system.

Audit Communication GAGAS require auditors to communicate information about the nature of the audit and the level of assurance provided not only to client management and

those charged with governance, but also to appropriate oversight bodies requiring the audits and to those legislative committees, if any, that have ongoing oversight responsibilities for the audited entity. In making these communications, the auditors should specifically address the work related to testing compliance with laws and regulations and internal control over financial reporting.

Considering the Results of Previous Audits GAGAS require the auditors to consider the results of previous audits and follow up on known significant findings and recommendations in prior-year audit reports. The auditors' objective is to determine that client officers have taken appropriate corrective actions. Auditors should use this information in assessing risk and determining the nature, timing, and extent of current audit work.

Noncompliance with Provisions of Contracts and Grants As discussed in Chapter 2, AICPA generally accepted auditing standards require the auditors to plan an audit to provide reasonable assurance of detecting violations of laws and regulations that have a direct and material effect on the financial statements. GAGAS make it clear that this responsibility extends to provisions of contracts and grants that have a direct and material effect on the financial statements.

Findings When the auditors identify findings, they should plan and perform procedures to develop the criteria, condition, cause, and effect of the findings. The auditors should also consider internal control deficiencies in their evaluation of identified findings.

Audit Documentation GAGAS also have additional documentation requirements beyond those required by AICPA generally accepted auditing standards. These documentation requirements include

- Before the report is issued, the auditors must document evidence of supervisory review of the work performed that supports findings, conclusions, and recommendations contained in the audit report.
- Any departures from GAGAS and the impact on the audit or the auditors' conclusions must be documented.

Reporting on Compliance with Laws and Regulations and Internal Control In performing an audit of financial statements in accordance with *Government Auditing Standards*, in addition to issuing an independent auditor's report on the financial statements, the auditor also must report on compliance with laws and regulations and on internal control.⁹

The auditors' reporting on compliance is based on the auditors' tests of compliance with laws, regulations, grants, and contracts that have a direct and material effect on the amounts in the financial statements—tests that are required by AICPA generally accepted auditing standards. The report describes the scope of the auditors' tests of compliance with laws and regulations and presents the auditors' findings.

Auditors may discover or suspect violations of provisions of laws, regulations, contracts, or grants that result in what they estimate to be a material misstatement of the organization's financial statements. In these circumstances, they must consider the effect on their opinion on the financial statements. The resulting misstatement, if left uncorrected, would normally require them to issue a qualified or adverse opinion. Of course, management will usually decide to correct the financial statements, allowing the auditors to issue an unqualified opinion. Even though the financial statements are corrected, the auditors must still modify their report on compliance with laws and regulations to include a description of the material instances of noncompliance. If the noncompliance resulted from a weakness in internal control considered by the auditors to be a significant deficiency, they also would modify their report on internal control to describe the condition. The auditors also should report a description of any material fraudulent or other illegal acts that they identify or suspect.

⁹ *Government Auditing Standards* allow these reports on internal control and compliance to be presented separately or combined. Usually, the auditors present a combined report.



Illustrative Case

Conflict Minerals

The Dodd-Frank Wall Street Reform and Consumer Protection Act includes a section related to “conflict minerals” mined in the Democratic Republic of the Congo (or an adjoining country). Conflict minerals are certain minerals—tantalum, tungsten, tin, and gold—mined in that area, often from mines controlled by violent militia groups. Under the act, certain SEC registrants are required to attempt to determine whether they use any of these minerals from that area in their products. These products include electronic devices such as cell phones, portable music players, and computers.

The act requires companies to establish and maintain a “due diligence framework” that makes it possible to monitor compliance with the act. Recently, Intel Corporation issued its report summarizing its analysis. While concluding that many of its products are DRC conflict free, for some products it found that it was unable to determine origin.

CPAs are able to follow *Government Auditing Standards* and attestation standards (Chapter 19) and express an opinion on

their client’s due diligence framework and compliance therewith (as contrasted to reporting directly on whether products are DRC conflict free). The following is the opinion paragraph from Ernst & Young’s report on Intel:

In our opinion, the design of the Company’s due diligence framework for the reporting period from January 1 to December 31, 2018, as set forth in the Design of Conflict Minerals Program section of the Conflict Minerals Report, is in conformity, in all material respects, with the OECD Due Diligence Guidance, and the Company’s description of the due diligence measures it performed as set forth in the Description of Due Diligence Measures Performed section of the Conflict Minerals Report for the reporting period from January 1 to December 31, 2018, is consistent, in all material respects, with the due diligence process that the Company undertook.

Ernst & Young’s report on Intel.

When performing an audit in accordance with *GAGAS*, the auditors should include all significant deficiencies in internal control in the audit report and identify those considered to be material weaknesses. If the auditors have sufficient appropriate audit evidence that a significant deficiency has been remediated (eliminated) before their report is issued, the report still includes the significant deficiency but indicates that it has been remediated. The report also includes a description of the scope of the auditors’ testing of internal control.¹⁰

The combined report on compliance and internal control over compliance begins with the report on compliance. That report has elements similar to a report on the audit of financial statements. It has an Opinion section that indicates what programs and requirements were included in the audit and expresses the auditors’ opinion on compliance. This is followed by a Basis of Opinion section that sets forth the nature of the audit and its limitations. The report concludes with sections on Management’s Responsibilities for Compliance and the Auditors’ Responsibilities.

The report on internal control over compliance (1) provides definitions of deficiency, significant deficiency, and material weakness in internal control over compliance; (2) states that the auditors’ consideration of internal control was not designed to find all deficiencies and not designed to express an opinion on internal control over compliance; and (3) describes any material weaknesses and significant deficiencies identified.

Auditors also may be required to report fraudulent or illegal acts, identified or suspected, directly to a government agency or another third party. For example, when the client is required by law or regulation to notify specific external parties about a fraudulent or illegal act and fails to do so, the auditors are required to communicate the problem directly to the appropriate party. When the client fails to take appropriate steps to address fraudulent or illegal acts, auditors also may be required to notify a government agency.

Audits in Accordance with the Single Audit Act

A major impetus for the demands for increased *compliance auditing* comes from the federal government, which provides billions of dollars in financial assistance annually

¹⁰ Auditors of SEC registrants also issue reports on internal control as a part of the audit. Chapter 18 presents details.

through various federal financial assistance programs. This federal financial assistance must be spent in accordance with the respective programs' requirements. Federal financial assistance is provided primarily to states and local governmental units, such as cities, counties, and school districts, and to nonprofit organizations, such as private colleges and universities and research institutes. Business organizations also may receive federal financial assistance.

Congress passed the **Single Audit Act** to provide a mechanism for improving the management of federal financial assistance programs by providing a statutory requirement to test compliance with laws and regulations and internal controls over program compliance requirements. The Single Audit Act applies to states, local governments, and nonprofit organizations that expend \$750,000 or more within a fiscal year in federal financial assistance. Audits in accordance with the Single Audit Act¹¹ are specifically designed to assess whether the billions of dollars in federal financial assistance are being managed and spent in accordance with applicable laws and regulations. Consequently, audits under the Single Audit Act are more extensive than audits of an organization's financial statements in accordance with AICPA generally accepted auditing standards and *Government Auditing Standards*.

The requirements of a single audit include determining and reporting on whether (1) the financial statements are presented fairly in all material respects in accordance with generally accepted accounting principles; (2) the schedule of expenditures of federal awards (illustrated in Figure 21.4) is fairly presented in all material respects in relation to the financial statements taken as a whole; and (3) the entity complied with the provisions of laws, regulations, and contracts or grants that may have a direct and material effect on each major federal financial assistance program. The requirements also include obtaining an understanding of internal control pertaining to compliance with the provisions of laws, regulations, contracts, or grants that may have a material effect on each major federal financial assistance program; assessing control risk; and performing tests of controls. With respect to internal control, auditors must report on the procedures performed, including any significant deficiencies identified, with specific identification of significant deficiencies that constitute material weaknesses.

FIGURE 21.4 Schedule of Federal Financial Assistance

CITY OF ROSEBUD, NEW JERSEY Schedule of Federal Financial Assistance For the Year Ended June 30, 20X1				
Federal Grantor	Federal CFDA Number	Program or Award Amount	Receipts	Disbursements
Department of Housing and Urban Development, Community Development Block Grants/Entitlement Grants	14.218	\$ 808,432	\$ 562,453	\$ 641,941
Passed through the New Jersey Department of Transportation: Federal Transit—Capital Investment Grants	20.500	483,993	483,993	483,993
Department of Education, Title I Grants to Local Education Agencies	84.010	158,700	—	30,910
		\$1,451,125	\$1,046,446	\$1,156,844

¹¹ The Single Audit Act requires the Director of the Office of Management and Budget (OMB) to issue guidance for implementing the act. OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, provides that guidance.



Illustrative Case

Identification of Major Programs

The City of Woodruff receives funds through four federal financial assistance programs. The following are the total amount of expenditures for the programs for the year and the auditors' assessments of the risk of material noncompliance of each program.

	Expenditures	Type	Risk
Department of Education			
Title I—Grants to Local Education Agencies			
CFDA Number 84.010	\$1,350,422	A	Moderate
Department of Transportation			
Highway Planning and Construction			
CFDA Number 20.205	787,900	A	Low
Department of Housing and Urban Development			
Community Development			
Block Grants/Entitlement Grants			
CFDA Number 14.218	340,000	B	High
Department of Health and Human Services			
Community Services Block Grant			
CFDA Number 93.569	95,200	B	Moderate
Total expenditures	<u>\$2,573,522</u>		

Based on the amount of the expenditures and the risk of material noncompliance, the auditors have identified the first and third programs as major programs. Expenditures from these two programs total \$1,690,422 (\$1,350,422 + \$340,000), which exceeds the required percentage of coverage of 50 percent of total federal financial assistance program expenditures. The second and fourth programs were not identified as major programs due to the auditors' assessments of the risk of material noncompliance and total amount, respectively.

Identification of Major Programs An important aspect of performing an audit in accordance with the Single Audit Act is auditor identification of the **major federal financial assistance programs**. Major federal financial assistance programs are those programs to which the auditor must apply procedures to test for compliance and to test the effectiveness of controls. A major program is determined using a risk-based approach that considers both the amount of the program's expenditures and the risk of material noncompliance. First, programs are classified as Type A (larger) or Type B (smaller) programs based on the amount of the program's expenditures.¹² The auditors then identify low-, moderate-, and high-risk programs by considering factors such as prior audit findings and changes in personnel or systems that significantly affect risk. Major programs generally include all Type A programs that are not identified as low risk and all Type B programs that are identified as high risk. In addition, unless the organization is considered to be a low-risk auditee, the auditors must test compliance and controls of programs with expenditures that, in the aggregate, equal 40 percent of total federal financial assistance program expenditures.¹³ The *Illustrative Case* provides an example of how the auditors identify major programs.

Designing Compliance Procedures for Major Programs Auditors approach a single audit in much the same way they approach an audit in accordance with AICPA generally accepted auditing standards, but they must consider the additional auditing requirements

¹² For organizations with federal expenditures from \$750,000 to \$25 million, Type A programs are those with expenditures of \$750,000 or more. Organizations with expenditures greater than \$25 million have a larger threshold.

¹³ For low-risk organizations, this percentage is reduced to 25 percent.

for individual major federal financial assistance programs. In performing an audit in accordance with AICPA generally accepted auditing standards, auditors are concerned with compliance with laws and regulations that could have a *direct* and *material* effect on the organization's financial statements. Under the Single Audit Act, auditors also are concerned with compliance with laws and regulations that could have a direct and material effect on each major federal financial assistance program. Because materiality must be considered on a program-by-program basis, materiality for planning the compliance procedures will typically be much less than that for the financial statements. Further, an amount that is material to one major federal financial assistance program may not be material to another major program because of differences in program size and the differing significance of particular compliance requirements to each program. This lower level of planning materiality results in an increase in the extent of tests of compliance.

In designing the tests of compliance procedures, auditors first assess the inherent risk of material noncompliance with laws and regulations applicable to each major program by considering various factors, such as the amount of the program expenditures and any changes made in the program. Auditors then assess the *control risk* related to the organization's administration of the programs. When controls are considered likely to be effective, the Single Audit Act requires auditors to obtain an understanding of controls over compliance for major programs, assess control risk, and perform tests of controls sufficient to support an assessment of low control risk. But when such controls are considered unlikely to be effective, auditors do not have to perform tests of controls.

Based on the auditors' assessments of the risks of material noncompliance and the related levels of control risk, they design sufficient substantive procedures to support an opinion on major program compliance with applicable laws and regulations. To provide assistance in designing these procedures, the Office of Management and Budget (OMB) issued *OMB Circular A-133 Compliance Supplement (Compliance Supplement)*, which specifies the compliance requirements and provides suggested audit procedures for a large number of federal financial assistance programs. For those major programs not included in the **Compliance Supplement**, auditors may determine the significant specific requirements to be tested by (1) following the *Compliance Supplement's* guidance for such programs; (2) considering knowledge obtained from prior years' audits; (3) discussing laws and regulations with management, lawyers, program administrators, or federal, state, and local auditors; and (4) reviewing grant and loan agreements.

Compliance Requirements Under the Single Audit Act, auditors must test for compliance with the specific requirements of all major programs. The **specific requirements** that must be audited are those that, if not complied with, could have a direct and material effect on a major program. These requirements and the related audit objectives are described as

1. *Activities allowed or not allowed.* Determine that the organization complies with the specific requirements regarding the activities allowed or not allowed by the program.
2. *Allowable costs/cost principles.* Determine that the organization complies with federal cost accounting policies applicable to the program.
3. *Cash management.* Determine that the **recipient/subrecipient** followed procedures to minimize the time elapsing between the transfer of funds from the U.S. Treasury, or pass-through entity, and their disbursement.
4. *Eligibility.* Determine that individuals or groups of individuals that are being provided goods or services under a program are eligible for participation in and for the levels of assistance received under that program.
5. *Equipment and real property management.* Determine that the organization safeguards and maintains equipment purchased with federal assistance and uses the equipment for appropriate purposes.
6. *Matching, level of effort, earmarking.* Determine that the organization contributes the appropriate amount of its own resources to the program.

7. *Period of performance.* Determine that federal funds were spent or obligated within the period of availability, unless authorized by the funding agency.
8. *Procurement and suspension and debarment.* Determine that the organization uses appropriate policies for purchases with federal funds and that the organization does not contract with vendors that are suspended or debarred.
9. *Program income.* Determine whether program income is correctly recorded and used in accordance with the program requirements.
10. *Reporting.* Determine that the organization has complied with prescribed reporting requirements.
11. *Subrecipient monitoring.* Determine whether recipients monitor the compliance of subrecipients.
12. *Special tests and provisions.* Determine that the organization complies with other significant specific requirements that apply to the program.

Evaluating the Results of Compliance Procedures of Major Programs In evaluating whether an entity's noncompliance is material to a major program, auditors should consider the frequency of noncompliance and whether it results in a material amount of questioned costs. A **questioned cost** is an expenditure that the auditor questions on the grounds that it does not meet the criteria for allowability, program eligibility, or other requirements or is not adequately supported with documentation. An example of a questioned cost is a payment of financial assistance to an individual who does not meet the eligibility requirements of a program. In evaluating the effect of the questioned cost on their reports, auditors not only consider the actual amount but also develop an estimate of the total amount of the questioned costs. Thus, when auditors use audit sampling to select expenditures for testing, they consider the *projected amount* of questioned costs from the sample, as discussed in Chapter 9. Even if the estimated total questioned cost is not material enough to affect the auditors' opinion on compliance, they may be required to report the instances of noncompliance found and the resulting amounts of questioned costs. Auditors must report all questioned costs and likely questioned costs that exceed \$25,000 in the Schedule of Findings and Questioned Costs, such as the example in Figure 21.5.

FIGURE 21.5
Schedule of Findings
and Questioned Costs

CITY OF WAXVILLE, WASHINGTON Schedule of Findings and Questioned Costs April 30, 20X1		
Program	Finding/Noncompliance	Questioned Cost
Department of Housing and Urban Development, Community Development Block Grants/Entitlement Grants Program		
1. Grant No. 85-C-7061 Project No. C-1 CFDA No. 14.218	Approximately \$11,800 was expended for the payment of individual homeowners' property taxes and fire insurance. These are not allowable costs. The City intends to repay HUD for these costs.	\$26,800
2. Grant No. 85-C-7071 Project No. C-1 CFDA No. 14.218	A request for reimbursement of funds was in excess of the actual documented expenditures. The City intends to repay HUD for these costs.	41,060 <u>\$67,860</u>

Reporting for a Single Audit In addition to the reports required for an audit in accordance with *Generally Accepted Government Auditing Standards*, auditors must report on

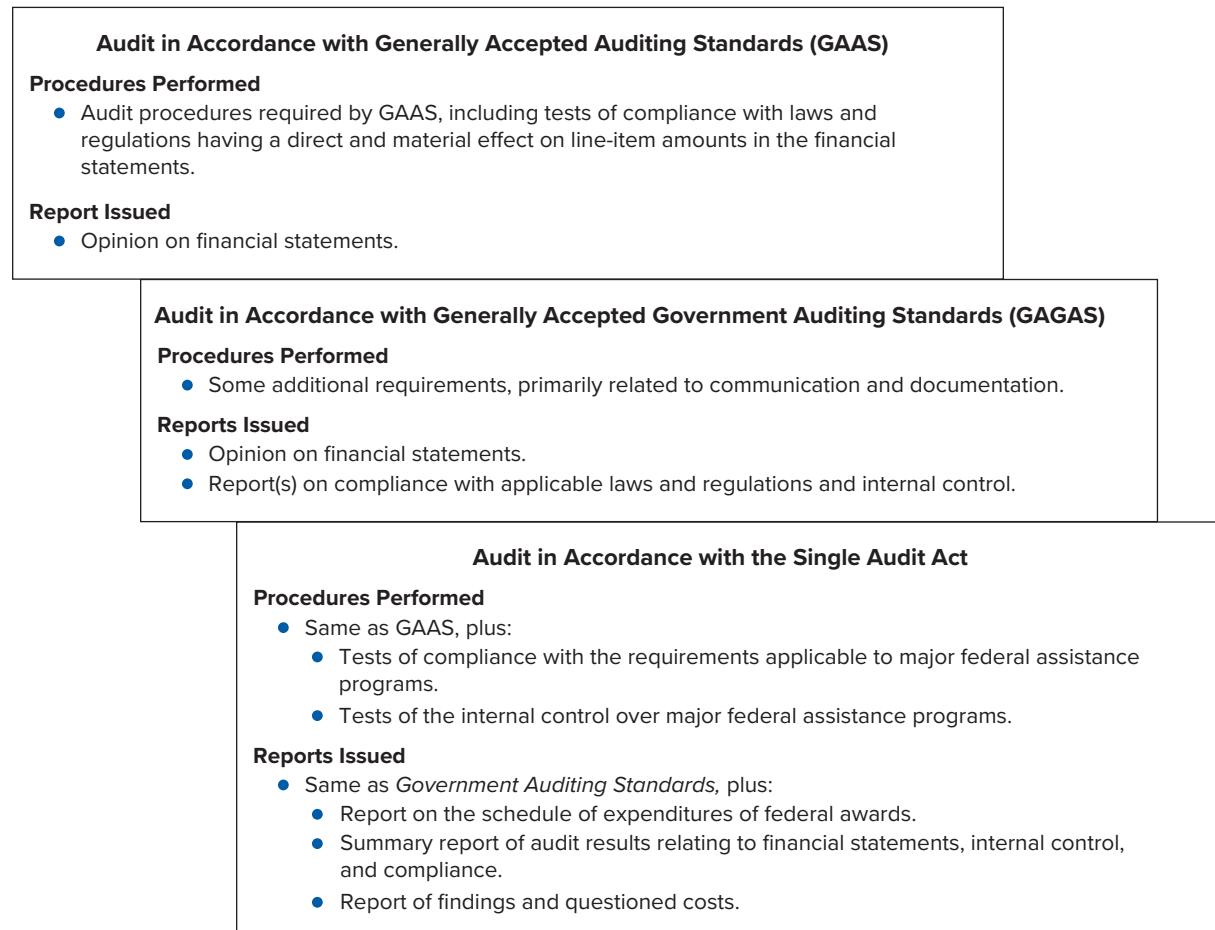
- Whether the schedule of expenditures of federal awards is fairly presented in all material respects in relation to the financial statements taken as a whole.
- Whether the entity complied with the provisions of laws, regulations, and contracts or grants that may have a direct and material effect on each major federal financial assistance program.
- The work performed on internal control relating to major federal financial assistance programs.

In addition, an auditor must prepare a *summary report* that summarizes the results of the audit as described in the auditor's opinion on the financial statements, reports on internal control, reports on compliance, and the schedule of findings and questioned costs that accompanies these reports.

Compliance Auditing—A Summary

The auditors' compliance auditing and reporting requirements are summarized in Figure 21.6. Notice that the requirements build on each other. An audit in accordance with *Generally Accepted Government Auditing Standards* includes the requirements of AICPA generally accepted auditing standards and a Single Audit includes the requirements of both standards.

FIGURE 21.6 Auditing and Reporting on Organizations Receiving Federal Financial Assistance—A Summary



Chapter Summary

This chapter described internal, operational, and compliance auditing. To summarize:

1. The Institute of Internal Auditors (IIA) defines *internal auditing* as an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluating and improving the effectiveness of risk management, control, and governance processes. The mission of internal auditing is to enhance and protect organizational value by providing risk-based and objective assurance, advice, and insight. The IIA's professional standards encompass attributes of internal auditors and performance of the internal audit function.
2. An *operational audit* is the examination of an operating unit or a complete organization to evaluate its performance, as measured by management's objectives. The stages of an operational audit might be summarized as definition of purpose, familiarization, preliminary survey, program development, fieldwork, reporting the findings, and follow-up.
3. *Compliance auditing* involves testing and reporting on whether an organization has complied with the requirements of various laws, regulations, and agreements.
4. The objective of a compliance audit engagement is the issuance of a report on the subject matter or an assertion by management regarding (a) the organization's compliance with specified requirements or (b) the organization's internal control over compliance with laws or regulations.
5. The objectives of compliance auditing of federal financial assistance programs are (a) to determine whether there have been violations of laws and regulations that may have a material effect on the organization's financial statements and major federal financial assistance programs and (b) to provide a basis for additional reports on compliance and internal controls. Compliance auditing is involved in audits of financial statements in accordance with AICPA generally accepted auditing standards, audits conducted in accordance with *Generally Accepted Government Auditing Standards*, and audits conducted in accordance with the federal Single Audit Act of 1984.
6. Audits of governmental organizations in accordance with AICPA generally accepted auditing standards must reflect the fact that such organizations are subject to a variety of laws and regulations that may have a direct and material effect on the amounts in the organization's financial statements.
7. In audits in accordance with *Generally Accepted Government Auditing Standards*, the auditors issue a report on the financial statements and also report on compliance with laws and regulations and on internal control.
8. Audits in conformity with the Single Audit Act of 1984 are specifically designed to help ensure that the billions of dollars in federal financial assistance are appropriately spent. The focus of these audits is on organizations receiving significant amounts of federal assistance in a year. The auditors are required to report on requirements of major programs for which federal assistance has been received.

Key Terms Introduced or Emphasized in Chapter 21

Broker-dealer (932) A person or firm in the business of buying and selling securities. A broker-dealer operates as a broker when it processes orders on behalf of clients and as a dealer when it trades for its own account.

Certified Internal Auditor (CIA) (926) An individual who has passed an examination administered by The Institute of Internal Auditors and has met the experience requirements necessary to become certified.

Charter (923) The charter of the internal audit activity is a formal written document that defines the activity's purpose, authority, and responsibility. The charter should (a) establish the internal audit

activity's position within the organization; (b) authorize access to records, personnel, and physical properties relevant to the performance of engagements; and (c) define the scope of internal audit activities.

Chief audit executive (925) Top position within the organization responsible for internal audit activities. Normally, this would be the internal audit director.

Compliance auditing (930) Performing procedures to test compliance with laws and regulations.

Compliance Supplement (939) A publication of the U.S. Office of Management and Budget that specifies audit procedures for federal financial assistance programs.

Compliance with specified requirements (930) An entity's compliance with specified requirements of laws, regulations, rules, contracts, or grants.

Government Auditing Standards (934) A document that contains standards for audits of government organizations, programs, activities, and functions and of government assistance received by contractors and other nonprofit organizations. These standards, often referred to as *Generally Accepted Government Auditing Standards (GAGAS)*, are to be followed by auditors when required by law or other requirement.

The Institute of Internal Auditors (IIA) (921) The international professional organization of internal auditors.

Internal auditing (921) An independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

Internal control over compliance (931) The process by which management obtains reasonable assurance of compliance with specified laws and regulations.

Major federal financial assistance program (award) (938) A significant federal assistance program as determined by the auditors based on a risk-based approach. In a single audit, the auditors must provide an opinion on compliance related to major programs.

Management's assertion (930) Any declaration, or set of related declarations taken as a whole, made by management. In the context of compliance attestation, management's assertion deals with the entity's compliance with specified requirements, the effectiveness of the entity's internal control over compliance, or both.

Mission of internal audit (921) (per IIA) To enhance and protect organizational value by providing risk-based and objective assurance, advice, and insight.

Noncompliance (930) The failure to act in accordance with laws, regulations, agreements, or grants.

Operational auditing (926) The process of reviewing a department or other unit of a business, governmental, or nonprofit organization to measure the effectiveness, efficiency, and economy of operations.

Questioned costs (940) Those costs paid with federal assistance that appear to be in violation of a law or regulation, inadequately documented, unnecessary, or unreasonable in amount.

Recipient (939) An organization receiving federal financial assistance directly from the federal agency administering the program.

Single Audit Act (937) Legislation passed by the U.S. Congress that establishes uniform requirements for audits of federal financial assistance provided to state and local governments. The act was significantly amended in 1996.

Specific requirements (939) In compliance attestation engagements, management asserts that the organization is in compliance with specified requirements, and the CPAs attest to this assertion.

Subrecipient (939) An organization receiving federal financial assistance passed through from a recipient.

Review Questions

- 21-1. Define internal auditing.
- 21-2. Describe the scope of activities of an internal auditing function.
- 21-3. Nearly every large corporation now maintains an internal auditing department, but 50 years ago relatively few companies carried on a formal program of internal auditing. What have been the principal factors responsible for this rapid expansion?
- 21-4. Identify the knowledge and skills that are necessary to the performance of modern internal auditing.
- 21-5. "The principal distinction between public accounting and internal auditing is that the latter activity is carried on by an organization's own salaried employees rather than by independent professional auditors." Criticize this quotation.

- 21-6. Compare the objectives of internal auditors with those of external auditors.
- 21-7. Identify the 11 categories of the IIA's *International Standards for the Professional Practice of Internal Auditing*.
- 21-8. Evaluate this statement: "Internal auditors cannot be independent of the activities that they audit."
- 21-9. Describe how the organizational status of the internal audit department affects its independence.
- 21-10. Briefly describe the factors that are important to the management of an internal auditing department.
- 21-11. Describe the requirements for becoming a certified internal auditor.
- 21-12. Differentiate between financial statement audits and operational audits.
- 21-13. Describe the purpose of an operational audit.
- 21-14. Should the internal auditors generally disclose their findings to operating personnel of the department involved before transmitting the report to top management? Explain.
- 21-15. Describe the two types of agreed-upon procedures engagements that CPAs may perform relating to compliance with laws and regulations.
- 21-16. Evaluate this statement: "An agreed-upon procedures engagement on compliance with a law is designed to provide users with negative assurance on whether an entity has complied with that law."
- 21-17. Describe the role of a broker-dealer.
- 21-18. Explain why tests of compliance with laws and regulations are considered to be substantive tests.
- 21-19. Explain the auditors' responsibility for testing compliance with laws and regulations in an audit in accordance with AICPA generally accepted auditing standards.
- 21-20. Identify the three types of audits that a governmental organization might obtain.
- 21-21. Describe the additional documentation requirements of *Generally Accepted Government Auditing Standards*.
- 21-22. Describe the ethical principles set forth in *Generally Accepted Government Auditing Standards*.
- 21-23. "In an audit in accordance with *Generally Accepted Government Auditing Standards*, the auditors must perform tests of compliance with all laws and regulations." Criticize this quotation.
- 21-24. Describe the additional reporting requirements of *Government Auditing Standards*.
- 21-25. The auditors' responsibility for reporting violations of laws and regulations under *Generally Accepted Government Auditing Standards* differs from their responsibility under AICPA generally accepted auditing standards. Compare these responsibilities.
- 21-26. Contrast the requirements of an audit in accordance with *Generally Accepted Government Auditing Standards* with the requirements of an audit in accordance with AICPA generally accepted auditing standards.
- 21-27. Explain why compliance with laws and regulations is so important in the audit of governmental organizations.
- 21-28. What is the purpose of the Single Audit Act?
- 21-29. When is an organization required to have an audit in accordance with the Single Audit Act?
- 21-30. Explain how major federal assistance programs are identified.
- 21-31. Describe what is meant by a questioned cost.
- 21-32. Distinguish between a subrecipient and a primary recipient. Provide an example of each.
- 21-33. Identify the 12 requirements that may be applicable to federal financial assistance programs.

Questions Requiring Analysis

Select questions are available with Connect.



- LO 21-1** 21–34. In order to function effectively, the internal auditor must often educate auditees and other parties about the nature and purpose of internal auditing.
- Define internal auditing.
 - Briefly describe three possible benefits of an internal audit department's program to educate auditees and other parties about the nature and purpose of internal auditing.
- (CIA, adapted)
- LO 21-1, 4, 5** 21–35. Steve Ankenbrandt, president of Beeb Corp., has been discussing the company's internal operations with the presidents of several other multidivision companies. Ankenbrandt discovered that most of them have an internal audit staff. The activities of the staffs at other companies include financial audits, operational audits, and sometimes compliance audits.
- Describe the meaning of the following terms as they relate to the internal auditing function:
- Financial auditing.
 - Operational auditing.
 - Compliance auditing.
- (CIA, adapted)
- LO 21-3** 21–36. Throughout this book, emphasis has been placed on the concept of independence as the most significant single element underlying the development of the public accounting profession. The term "independent auditor" is sometimes used to distinguish the public accountant from an internal auditor. Nevertheless, The Institute of Internal Auditors points to the factor of independence as essential to an effective program of internal auditing. Distinguish between the meaning of *independence* as used by the American Institute of Certified Public Accountants in describing the function of the certified public accountant and the meaning of *independence* as used by The Institute of Internal Auditors to describe the work of the internal auditor.
- LO 21-1, 3** 21–37. You are conducting the first audit of the marketing activities of your organization. Your preliminary survey has disclosed indications of deficient conditions of a serious nature. You expect your audit work to document the need for substantial corrective action. You feel certain that your audit report will contain descriptions of a number of serious defects. Your preliminary meeting with the director of the marketing division and the principal subordinates gave you reason to believe that they will be defensive, that your audit report will receive a chilly reception, that your stated facts are likely to be challenged, and that any deficient conditions reported will be denied or minimized.
- Identify the aspect of the *International Standards for the Professional Practice of Internal Auditing* that applies to the described problems. You may use Appendix 21A to assist you with replying to this problem.
 - Describe four techniques that you might use to improve the chances that your report will be well received and that appropriate corrective action will be taken.
- (CIA, adapted)
- LO 21-5** 21–38. CPAs may become involved in examinations of broker-dealers.
- Describe the information a broker-dealer who maintains custody of customer funds or securities is required to file in an annual compliance report.
 - Which of the required information in part (a) will ordinarily be examined and reported upon by a CPA?
- LO 21-5** 21–39. Matt Gunlock, CPA, is performing an audit of the City of Ryan in accordance with AICPA generally accepted auditing standards.
- Must Matt be concerned with the city's compliance with laws and regulations? Explain.
 - How should Matt decide on the nature and extent of the tests of compliance that should be performed in the audit?
- LO 21-6** 21–40. Wixon & Co., CPAs, is performing an audit of the City of Brummet for the year ended June 30, 200X, in accordance with *Generally Accepted Government Auditing Standards*. During the course of the audit, Gerald Yarnell, a senior auditor, discovers violations of laws and regulations that constitute material instances of noncompliance.
- Explain how these violations may affect the auditors' reports.
 - How would your answer to requirement (a) change if management elected to correct the financial statements for the violations?

- LO 21-6** 21–41. North County School District expended \$1,450,000 in federal financial assistance this year.
- Is North County School District required to have an audit in accordance with the Single Audit Act? Explain.
 - What are the requirements of an audit in accordance with the Single Audit Act?
- LO 21-6** 21–42. The City of Westmore is confused about the type of audit that it should obtain: an audit in accordance with AICPA generally accepted auditing standards, an audit in accordance with *Generally Accepted Government Auditing Standards*, or an audit in accordance with the Single Audit Act.
- Explain the differences between the three types of audits.
 - How should the City of Westmore decide which type of audit it is required to obtain?

Objective Questions

- LO 21-1** 21–43. **Multiple Choice Questions**
Select the best answer for each of the following questions. Explain the reasons for your selection.
- LO 21-1** a. Internal auditing can best be described as:
- An accounting function.
 - A compliance function.
 - An activity primarily to detect fraud.
 - A control function.
- (CIA, adapted)
- LO 21-1** b. The independence of the internal auditing department will most likely be assured if it reports to the:
- Audit committee of the board of directors.
 - President.
 - Controller.
 - Treasurer.
- (CIA, adapted)
- LO 21-1** c. When performing an operational audit, the purpose of a preliminary survey is to:
- Determine the objective of the activity to be audited.
 - Determine the scope of the audit.
 - Identify areas that should be included in the audit program.
 - All of the above.
- (CIA, adapted)
- LO 21-4** d. Operational auditing is primarily oriented toward:
- Future improvements to accomplish the goals of management.
 - Ensuring the accuracy of the data in management's financial reports.
 - Determination of the fairness of the entity's financial statements.
 - Compliance with laws and regulations.
- LO 21-6** e. Which of the following bodies promulgates standards for audits of federal financial assistance programs?
- Governmental Accounting Standards Board.
 - Financial Accounting Standards Board.
 - Government Accountability Office.
 - Governmental Auditing Standards Board.
- (CIA, adapted)
- LO 21-6** f. As compared to an audit in accordance with GAAS, an audit in accordance with *Generally Accepted Government Auditing Standards* requires the auditors to:
- Use a lower level of materiality.
 - Perform additional tests of internal control.
 - Issue an additional report on compliance with laws and regulations and internal control.
 - Fulfill all of the above requirements.

LO 21-5

- g. In a compliance attestation engagement, CPAs may address an organization's:

	Compliance with Specified Requirements	Internal Control over Compliance with Specific Laws and Regulations
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

LO 21-5

- h. The portion of internal control most directly related to a CPA's engagement to attest to compliance with laws and regulations is:

- (1) Internal control over compliance.
- (2) Internal control over financial reporting.
- (3) Internal control over laws and regulations.
- (4) Internal control over operations.

LO 21-5

- i. When issuing an unqualified audit report in a compliance attestation engagement, the CPA may report on:

	Management's Assertion	Subject Matter
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

LO 21-5

- j. When issuing a qualified audit report in a compliance attestation engagement, the CPA may report on:

	Management's Assertion	Subject Matter
(1)	Yes	Yes
(2)	Yes	No
(3)	No	Yes
(4)	No	No

LO 21-6

- k. An important aspect of performing an audit in accordance with the Single Audit Act is to identify:

- (1) Major federal financial assistance programs.
- (2) Government generally accepted assertions.
- (3) Federal supplemental requirements.
- (4) Title determination sub-acts.

LO 21-1

- l. The organization that administers the Certified Internal Auditor program is the:
- (1) American Institute of Certified Public Accountants—Certified Internal Auditor Division.
 - (2) The Institute of Internal Auditors.
 - (3) American Accounting Association.
 - (4) Securities and Exchange Commission.

LO 21-6

21-44. Simulation

Under the Single Audit Act, auditors must test for compliance with the specific requirements of all major programs. State whether each of the following is required under that act:

Statement	Is it required?
a. Determine that the organization complies with generally accepted accounting principles applicable to the program.	
b. Determine that the organization complies with specific requirements regarding the activities allowed or not allowed by the program.	
c. Determine that wages paid are not more than those established for the locality of the project by the Department of Labor.	

Statement	Is it required?
d. Determine that the organization contributes the appropriate amount of its own resources to the program.	
e. Determine that federal funds were spent or obligated within the period of availability.	
f. Determine whether program income is correctly recorded and used in accordance with the program requirements.	
g. Determine whether subrecipients monitor the compliance of recipients.	
h. Determine that only registered U.S. citizens work on the program.	
i. Determine that the organization does not contract with vendors that are suspended or debarred.	
j. Determine that the organization followed procedures to minimize the time elapsing between the transfer of funds from the U.S. Treasury and their disbursement.	

LO 21-5, 6

- 21–45. Match the following terms with the appropriate definition (or partial definition). Each definition may be used once or not at all.

Term	Definition (or Partial Definition)
a. Compliance auditing	1. A document that contains standards for audits of government organizations, programs, activities, and functions and of government assistance received by contractors and other nonprofit organizations.
b. Compliance Supplement	2. A document that presents the major and minor program requirements for all federal contracts.
c. Government Auditing Standards	3. A publication of the U.S. Office of Management and Budget that specifies audit procedures for federal financial assistance programs.
d. Major federal financial assistance program	4. A supplement to the U.S. Business Code, published by the Government Accountability Office, dealing with overall compliance issues.
e. Single Audit Act	5. An act requiring that every single municipality undergo an annual audit of its financial statements.
	6. Legislation passed by the U.S. Congress that establishes uniform requirements for audits of federal financial assistance provided to state and local governments.
	7. Performing procedures to test compliance with laws and regulations.
	8. A significant federal assistance program as determined by the auditors based on a risk-based approach. In a single audit, the auditors must provide an opinion on compliance related to major programs.
	9. The process of reviewing a department or other unit of a business, governmental, or nonprofit organization to measure the effectiveness, efficiency, and economy of operations.

Problems
LO 21-1, 3

- 21–46. You are the chief audit executive for the internal auditing function of a large municipal hospital. You receive monthly financial reports prepared by the accounting department, and your review of them has shown that total accounts receivable from patients have steadily and rapidly increased over the past eight months.
- Other information in the reports shows the following conditions:
1. The number of available hospital beds has not changed.
 2. The bed occupancy rate has not changed.
 3. Hospital billing rates have not changed significantly.
 4. The hospitalization insurance contracts have not changed since the last modification 12 months ago.

Your internal audit department performed a financial and operational audit of the accounts receivable accounting function 10 months ago. The working papers file for that assignment contains financial information, a record of the preliminary survey, documentation of the study, evaluation of controls, documentation of the procedures used to produce evidence about the validity and collectibility of the accounts, and a copy of your report that commented favorably on the controls and collectibility of the receivables.

However, the current increase in receivables has alerted you to the need for another audit. You remember news stories last year about the manager of the city water system who lost his job because his accounting department double-billed all the residential customers for three months. You plan to perform a preliminary survey of the problem, if indeed a problem exists.

- a. Write a memo to your senior auditor listing at least eight questions that should be used to guide and direct the preliminary survey. (*Hint: The categories of questions used in the last preliminary survey were these: Who does the accounts receivable accounting? What data processing procedures and policies are in effect? and How is the accounts receivable accounting done? This time, you will use these categories and add a fourth category of questions: What financial or economic events have occurred in the past 10 months?*)
- b. Describe the phases of the audit that would be performed after the preliminary survey is completed.

(CIA, adapted)

- LO 21-3** 21–47. Devry Corporation has established an independent foundation for the purposes of community improvement. The foundation employs an executive director and eight staff people. The internal auditors of the company were requested to do an audit of the foundation in 20X1 to determine problems with the recording of transactions, the handling of cash, and documentation of transactions. The following items were found:

1. The foundation used the cash basis of reporting rather than the accrual basis.
2. The foundation lacked a copy of the plane ticket for airfare reimbursed for a trip taken by one of the volunteers.
3. Excess funds were invested in instruments other than those specified by the organization's policy manual.
4. The purchase of a desktop publishing system was expensed.
5. The foundation does not employ anyone with formal accounting training.
6. Many errors were made in recording transactions, which necessitated many year-end adjusting entries.
7. Numerous certificates of deposit were found in many different locations (e.g., filing cabinets, desk drawers, and a safe deposit box).
8. The checking account was reconciled by the individual who wrote the checks.

Write an internal audit report (in proper form) to the executive committee of the foundation indicating findings and recommendations.

(CIA, adapted)

- LO 21-6** 21–48. In performing an audit in accordance with *Generally Accepted Government Auditing Standards*, the auditors are required to issue an additional combined report on compliance with laws and regulations and on internal control.

- a. Describe the nature of the procedures that the auditors must perform beyond those required by AICPA generally accepted auditing standards to provide a basis for this report.
- b. Describe the specific contents of the auditors' combined report on compliance and internal control.

- LO 21-6** 21–49. In performing an audit in accordance with both AICPA generally accepted auditing standards and *Generally Accepted Government Auditing Standards*, the auditors are required to communicate information about weaknesses in the organization's internal control. However, the requirements are different.

- a. Describe the differences between these requirements.
- b. Describe the major aspects of the report on internal control required by *Government Auditing Standards*.

In-Class Team Case

LO 21-6

21–50.

Robert Myers, CPA, has been engaged to audit the City of Mystic in accordance with the Single Audit Act. Robert is aware that the Single Audit Act requires additional tests of major federal financial assistance programs, and he is trying to identify those programs for this audit. The City of Mystic participates in four federal financial assistance programs with the following amounts of expenditures and assessed risk of material noncompliance.



Grant Program	Expenditures	Risk
Department of Education, Title I Grants to Local Education Agencies	\$ 2,370,000	High
Environmental Protection Agency, Ford Creek Modification	6,780,000	Moderate
Department of Housing and Urban Development		
Project # C94-MC-08-0009	5,500,000	Low
Project # C94-MC-08-0010	350,000	Moderate
Total grant awards	<u>\$15,000,000</u>	

Required:

- a. Identify the major federal assistance programs.
- b. Describe the compliance testing requirements for major federal financial assistance programs under the Single Audit Act.

Appendix 21A

International Standards for the Practice of Internal Auditing

Attribute Standards

Attribute *Standards* address the characteristics of organizations and parties performing internal audit activities.

1000—PURPOSE, AUTHORITY, AND RESPONSIBILITY

The purpose, authority, and responsibility of the internal audit activity must be formally defined in an internal audit charter, consistent with the Mission of Internal Audit and the mandatory elements of the International Professional Practices Framework (the Core Principles for the Professional Practice of Internal Auditing, the Code of Ethics, the *Standards*, and the Definition of Internal Auditing). The chief audit executive must periodically review the internal audit charter and present it to senior management and the board for approval.

Interpretation

The internal audit charter is a formal document that defines the internal audit activity's purpose, authority, and responsibility. The internal audit charter establishes the internal audit activity's position within the organization, including the nature of the chief audit executive's functional reporting relationship with the board; authorizes access to records, personnel, and physical properties relevant to the performance of engagements; and defines the scope of internal audit activities. Final approval of the internal audit charter resides with the board.

1000.A1—The nature of assurance services provided to the organization must be defined in the internal audit charter. If assurances are to be provided to parties outside the organization, the nature of these assurances must also be defined in the internal audit charter.

1000.C1—The nature of consulting services must be defined in the internal audit charter.

1010—RECOGNIZING MANDATORY GUIDANCE IN THE INTERNAL AUDIT CHARTER

The mandatory nature of the Core Principles for the Professional Practice of Internal Auditing, the Code of Ethics, the *Standards*, and the Definition of Internal Auditing must be recognized in the internal audit charter. The chief audit executive should discuss the Mission of Internal Audit and the mandatory elements of the International Professional Practices Framework with senior management and the board.

1100—INDEPENDENCE AND OBJECTIVITY

The internal audit activity must be independent, and internal auditors must be objective in performing their work.

Interpretation

Independence is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the chief audit executive has direct and unrestricted access to senior

management and the board. This can be achieved through a dual-reporting relationship. Threats to independence must be managed at the individual auditor, engagement, functional, and organizational levels.

Objectivity is an unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no quality compromises are made. Objectivity requires that internal auditors do not subordinate their judgment on audit matters to others. Threats to objectivity must be managed at the individual auditor, engagement, functional, and organizational levels.

1110—ORGANIZATIONAL INDEPENDENCE

The chief audit executive must report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. The chief audit executive must confirm to the board, at least annually, the organizational independence of the internal audit activity.

Interpretation

Organizational independence is effectively achieved when the chief audit executive reports functionally to the board. Examples of functional reporting to the board involve the board:

- *Approving the internal audit charter.*
- *Approving the risk based internal audit plan.*
- *Approving the internal audit budget and resource plan.*
- *Receiving communications from the chief audit executive on the internal audit activity's performance relative to its plan and other matters.*
- *Approving decisions regarding the appointment and removal of the chief audit executive.*
- *Approving the remuneration of the chief audit executive.*
- *Making appropriate inquiries of management and the chief audit executive to determine whether there are inappropriate scope or resource limitations.*

1110.A1—The internal audit activity must be free from interference in determining the scope of internal auditing, performing work, and communicating results.

The chief audit executive must disclose such interference to the board and discuss the implications.

1111—DIRECT INTERACTION WITH THE BOARD

The chief audit executive must communicate and interact directly with the board.

1112—CHIEF AUDIT EXECUTIVE ROLES BEYOND INTERNAL AUDITING

Where the chief audit executive has or is expected to have roles and/or responsibilities that fall outside of internal auditing, safeguards must be in place to limit impairments to independence or objectivity.

Interpretation

The chief audit executive may be asked to take on additional roles and responsibilities outside of internal auditing, such as responsibility for compliance or risk management activities. These roles and responsibilities may impair, or appear to impair, the organizational independence of the internal audit activity or the individual objectivity of the internal auditor. Safeguards are those oversight activities, often undertaken by the board, to address these potential impairments, and may include such activities as periodically evaluating reporting lines and responsibilities and developing alternative processes to obtain assurance related to the areas of additional responsibility.

1120—INDIVIDUAL OBJECTIVITY

Internal auditors must have an impartial, unbiased attitude and avoid any conflict of interest.

Interpretation

Conflict of interest is a situation in which an internal auditor, who is in a position of trust, has a competing professional or personal interest. Such competing interests can make it difficult to fulfill his or her duties impartially. A conflict of interest exists even if no unethical or improper act results. A conflict of interest can create an appearance of impropriety that can undermine confidence in the internal auditor, the internal audit activity, and the profession. A conflict of interest could impair an individual's ability to perform his or her duties and responsibilities objectively.

1130—IMPAIRMENT TO INDEPENDENCE OR OBJECTIVITY

If independence or objectivity is impaired in fact or appearance, the details of the impairment must be disclosed to appropriate parties. The nature of the disclosure will depend upon the impairment.

Interpretation

Impairment to organizational independence and individual objectivity may include, but is not limited to, personal conflict of interest, scope limitations, restrictions on access to records, personnel, and properties, and resource limitations, such as funding.

The determination of appropriate parties to which the details of an impairment to independence or objectivity must be disclosed is dependent upon the expectations of the internal audit activity's and the chief audit executive's responsibilities to senior management and the board as described in the internal audit charter, as well as the nature of the impairment.

1130.A1—Internal auditors must refrain from assessing specific operations for which they were previously responsible. Objectivity is presumed to be impaired if an internal auditor provides assurance services for an activity for which the internal auditor had responsibility within the previous year.

1130.A2—Assurance engagements for functions over which the chief audit executive has responsibility must be overseen by a party outside the internal audit activity.

1130.A3—The internal audit activity may provide assurance services where it had previously performed consulting services, provided the nature of the consulting did not impair objectivity and provided individual objectivity is managed when assigning resources to the engagement.

1130.C1—Internal auditors may provide consulting services relating to operations for which they had previous responsibilities.

1130.C2—If internal auditors have potential impairments to independence or objectivity relating to proposed consulting services, disclosure must be made to the engagement client prior to accepting the engagement.

1200—PROFICIENCY AND DUE PROFESSIONAL CARE

Engagements must be performed with proficiency and due professional care.

1210—PROFICIENCY

Internal auditors must possess the knowledge, skills, and other competencies needed to perform their individual responsibilities. The internal audit activity collectively must possess or obtain the knowledge, skills, and other competencies needed to perform its responsibilities.

Interpretation

Proficiency is a collective term that refers to the knowledge, skills, and other competencies required of internal auditors to effectively carry out their professional responsibilities. It encompasses consideration of current activities, trends, and emerging issues, to enable relevant advice and recommendations. Internal auditors are encouraged to demonstrate

their proficiency by obtaining appropriate professional certifications and qualifications, such as the Certified Internal Auditor designation and other designations offered by The Institute of Internal Auditors and other appropriate professional organizations.

1210.A1—The chief audit executive must obtain competent advice and assistance if the internal auditors lack the knowledge, skills, or other competencies needed to perform all or part of the engagement.

1210.A2—Internal auditors must have sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organization, but are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud.

1210.A3—Internal auditors must have sufficient knowledge of key information technology risks and controls and available technology-based audit techniques to perform their assigned work. However, not all internal auditors are expected to have the expertise of an internal auditor whose primary responsibility is information technology auditing.

1210.C1—The chief audit executive must decline the consulting engagement or obtain competent advice and assistance if the internal auditors lack the knowledge, skills, or other competencies needed to perform all or part of the engagement.

1220—DUE PROFESSIONAL CARE

Internal auditors must apply the care and skill expected of a reasonably prudent and competent internal auditor. Due professional care does not imply infallibility.

1220.A1—Internal auditors must exercise due professional care by considering the:

- Extent of work needed to achieve the engagement's objectives.
- Relative complexity, materiality, or significance of matters to which assurance procedures are applied.
- Adequacy and effectiveness of governance, risk management, and control processes.
- Probability of significant errors, fraud, or noncompliance.
- Cost of assurance in relation to potential benefits.

1220.A2—In exercising due professional care internal auditors must consider the use of technology-based audit and other data analysis techniques.

1220.A3—Internal auditors must be alert to the significant risks that might affect objectives, operations, or resources. However, assurance procedures alone, even when performed with due professional care, do not guarantee that all significant risks will be identified.

1220.C1—Internal auditors must exercise due professional care during a consulting engagement by considering the:

- Needs and expectations of clients, including the nature, timing, and communication of engagement results.
- Relative complexity and extent of work needed to achieve the engagement's objectives.
- Cost of the consulting engagement in relation to potential benefits.

1230—CONTINUING PROFESSIONAL DEVELOPMENT

Internal auditors must enhance their knowledge, skills, and other competencies through continuing professional development.

1300—QUALITY ASSURANCE AND IMPROVEMENT PROGRAM

The chief audit executive must develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity.

Interpretation

A quality assurance and improvement program is designed to enable an evaluation of the internal audit activity's conformance with the Standards and an evaluation of whether internal auditors apply the Code of Ethics. The program also assesses the efficiency and effectiveness of the internal audit activity and identifies opportunities for improvement. The chief audit executive should encourage board oversight in the quality assurance and improvement program.

1310—REQUIREMENTS OF THE QUALITY ASSURANCE AND IMPROVEMENT PROGRAM

The quality assurance and improvement program must include both internal and external assessments.

1311—INTERNAL ASSESSMENTS

Internal assessments must include:

- Ongoing monitoring of the performance of the internal audit activity.
- Periodic self-assessments or assessments by other persons within the organization with sufficient knowledge of internal audit practices.

Interpretation

Ongoing monitoring is an integral part of the day-to-day supervision, review, and measurement of the internal audit activity. Ongoing monitoring is incorporated into the routine policies and practices used to manage the internal audit activity and uses processes, tools, and information considered necessary to evaluate conformance with the Code of Ethics and the Standards.

Periodic assessments are conducted to evaluate conformance with the Code of Ethics and the Standards.

Sufficient knowledge of internal audit practices requires at least an understanding of all elements of the International Professional Practices Framework.

1312—EXTERNAL ASSESSMENTS

External assessments must be conducted at least once every five years by a qualified, independent assessor or assessment team from outside the organization. The chief audit executive must discuss with the board:

- The form and frequency of external assessments.
- The qualifications and independence of the external assessor or assessment team, including any potential conflict of interest.

Interpretation

External assessments may be accomplished through a full external assessment, or a self-assessment with independent external validation. The external assessor must conclude as to conformance with the Code of Ethics and the Standards; the external assessment may also include operational or strategic comments.

A qualified assessor or assessment team demonstrates competence in two areas: the professional practice of internal auditing and the external assessment process. Competence can be demonstrated through a mixture of experience and theoretical learning. Experience gained in organizations of similar size, complexity, sector or industry, and technical issues is more valuable than less relevant experience. In the case of an assessment team, not all members of the team need to have all the competencies; it is the team as a whole that is qualified. The chief audit executive uses professional judgment when assessing whether an assessor or assessment team demonstrates sufficient competence to be qualified.

An independent assessor or assessment team means not having either an actual or a perceived conflict of interest and not being a part of, or under the control of, the organization to which the internal audit activity belongs. The chief audit executive should encourage board oversight in the external assessment to reduce perceived or potential conflicts of interest.

1320—REPORTING ON THE QUALITY ASSURANCE AND IMPROVEMENT PROGRAM

The chief audit executive must communicate the results of the quality assurance and improvement program to senior management and the board. Disclosure should include:

- The scope and frequency of both the internal and external assessments.
- The qualifications and independence of the assessor(s) or assessment team, including potential conflicts of interest.
- Conclusions of assessors.
- Corrective action plans.

Interpretation

The form, content, and frequency of communicating the results of the quality assurance and improvement program is established through discussions with senior management and the board and considers the responsibilities of the internal audit activity and chief audit executive as contained in the internal audit charter. To demonstrate conformance with the Code of Ethics and the Standards, the results of external and periodic internal assessments are communicated upon completion of such assessments, and the results of ongoing monitoring are communicated at least annually. The results include the assessor's or assessment team's evaluation with respect to the degree of conformance.

1321—USE OF “CONFORMS WITH THE INTERNATIONAL STANDARDS FOR THE PROFESSIONAL PRACTICE OF INTERNAL AUDITING”

Indicating that the internal audit activity conforms with the *International Standards for the Professional Practice of Internal Auditing* is appropriate only if supported by the results of the quality assurance and improvement program.

Interpretation

The internal audit activity conforms with the Code of Ethics and the Standards when it achieves the outcomes described therein. The results of the quality assurance and improvement program include the results of both internal and external assessments. All internal audit activities will have the results of internal assessments. Internal audit activities in existence for at least five years will also have the results of external assessments.

1322—DISCLOSURE OF NONCONFORMANCE

When nonconformance with the Code of Ethics or the *Standards* impacts the overall scope or operation of the internal audit activity, the chief audit executive must disclose the nonconformance and the impact to senior management and the board.

Performance Standards

Performance *Standards* describe the nature of internal audit activities and provide criteria against which the performance of these services can be evaluated.

2000—MANAGING THE INTERNAL AUDIT ACTIVITY

The chief audit executive must effectively manage the internal audit activity to ensure it adds value to the organization.

Interpretation

The internal audit activity is effectively managed when:

- *It achieves the purpose and responsibility included in the internal audit charter.*
- *It conforms with the Standards.*
- *Its individual members conform with the Code of Ethics and the Standards.*
- *It considers trends and emerging issues that could impact the organization.*

The internal audit activity adds value to the organization and its stakeholders when it considers strategies, objectives, and risks; strives to offer ways to enhance governance, risk management, and control processes; and objectively provides relevant assurance.

2010—PLANNING

The chief audit executive must establish a risk-based plan to determine the priorities of the internal audit activity, consistent with the organization's goals.

Interpretation

To develop the risk-based plan, the chief audit executive consults with senior management and the board and obtains an understanding of the organization's strategies, key business objectives, associated risks, and risk management processes. The chief audit executive must review and adjust the plan, as necessary, in response to changes in the organization's business, risks, operations, programs, systems, and controls.

2010.A1—The internal audit activity's plan of engagements must be based on a documented risk assessment, undertaken at least annually. The input of senior management and the board must be considered in this process.

2010.A2—The chief audit executive must identify and consider the expectations of senior management, the board, and other stakeholders for internal audit opinions and other conclusions.

2010.C1—The chief audit executive should consider accepting proposed consulting engagements based on the engagement's potential to improve management of risks, add value, and improve the organization's operations. Accepted engagements must be included in the plan.

2020—COMMUNICATION AND APPROVAL

The chief audit executive must communicate the internal audit activity's plans and resource requirements, including significant interim changes, to senior management and the board for review and approval. The chief audit executive must also communicate the impact of resource limitations.

2030—RESOURCE MANAGEMENT

The chief audit executive must ensure that internal audit resources are appropriate, sufficient, and effectively deployed to achieve the approved plan.

Interpretation

Appropriate refers to the mix of knowledge, skills, and other competencies needed to perform the plan. Sufficient refers to the quantity of resources needed to accomplish the plan. Resources are effectively deployed when they are used in a way that optimizes the achievement of the approved plan.

2040—POLICIES AND PROCEDURES

The chief audit executive must establish policies and procedures to guide the internal audit activity.

Interpretation

The form and content of policies and procedures are dependent upon the size and structure of the internal audit activity and the complexity of its work.

2050—COORDINATION AND RELIANCE

The chief audit executive should share information, coordinate activities, and consider relying upon the work of other internal and external assurance and consulting service providers to ensure proper coverage and minimize duplication of efforts.

Interpretation

In coordinating activities, the chief audit executive may rely on the work of other assurance and consulting service providers. A consistent process for the basis of reliance should be established, and the chief audit executive should consider the competency, objectivity, and due professional care of the assurance and consulting service providers. The chief audit executive should also have a clear understanding of the scope, objectives, and results of the work performed by other providers of assurance and consulting services. Where reliance is placed on the work of others, the chief audit executive is still accountable and responsible for ensuring adequate support for conclusions and opinions reached by the internal audit activity.

2060—REPORTING TO SENIOR MANAGEMENT AND THE BOARD

The chief audit executive must report periodically to senior management and the board on the internal audit activity's purpose, authority, responsibility, and performance relative to its plan and on its conformance with the Code of Ethics and the *Standards*. Reporting must also include significant risk and control issues, including fraud risks, governance issues, and other matters that require the attention of senior management and/or the board.

Interpretation

The frequency and content of reporting are determined collaboratively by the chief audit executive, senior management, and the board. The frequency and content of reporting depends on the importance of the information to be communicated and the urgency of the related actions to be taken by senior management and/or the board.

The chief audit executive's reporting and communication to senior management and the board must include information about:

- *The audit charter.*
- *Independence of the internal audit activity.*
- *The audit plan and progress against the plan.*
- *Resource requirements.*
- *Results of audit activities.*
- *Conformance with the Code of Ethics and the Standards, and action plans to address any significant conformance issues.*
- *Management's response to risk that, in the chief audit executive's judgment, may be unacceptable to the organization.*

These and other chief audit executive communication requirements are referenced throughout the Standards.

2070—EXTERNAL SERVICE PROVIDER AND ORGANIZATIONAL RESPONSIBILITY FOR INTERNAL AUDITING

When an external service provider serves as the internal audit activity, the provider must make the organization aware that the organization has the responsibility for maintaining an effective internal audit activity.

Interpretation

This responsibility is demonstrated through the quality assurance and improvement program which assesses conformance with the Code of Ethics and the Standards.

2100—NATURE OF WORK

The internal audit activity must evaluate and contribute to the improvement of the organization's governance, risk management, and control processes using a systematic, disciplined,

and risk-based approach. Internal audit credibility and value are enhanced when auditors are proactive and their evaluations offer new insights and consider future impact.

2110—GOVERNANCE

The internal audit activity must assess and make appropriate recommendations to improve the organization's governance processes for:

- Making strategic and operational decisions.
- Overseeing risk management and control.
- Promoting appropriate ethics and values within the organization.
- Ensuring effective organizational performance management and accountability.
- Communicating risk and control information to appropriate areas of the organization.
- Coordinating the activities of, and communicating information among, the board, external and internal auditors, other assurance providers, and management.

2110.A1—The internal audit activity must evaluate the design, implementation, and effectiveness of the organization's ethics-related objectives, programs, and activities.

2110.A2—The internal audit activity must assess whether the information technology governance of the organization supports the organization's strategies and objectives.

2120—RISK MANAGEMENT

The internal audit activity must evaluate the effectiveness and contribute to the improvement of risk management processes.

Interpretation

Determining whether risk management processes are effective is a judgment resulting from the internal auditor's assessment that:

- *Organizational objectives support and align with the organization's mission.*
- *Significant risks are identified and assessed.*
- *Appropriate risk responses are selected that align risks with the organization's risk appetite.*
- *Relevant risk information is captured and communicated in a timely manner across the organization, enabling staff, management, and the board to carry out their responsibilities.*

The internal audit activity may gather the information to support this assessment during multiple engagements. The results of these engagements, when viewed together, provide an understanding of the organization's risk management processes and their effectiveness.

Risk management processes are monitored through ongoing management activities, separate evaluations, or both.

2120.A1—The internal audit activity must evaluate risk exposures relating to the organization's governance, operations, and information systems regarding the:

- Achievement of the organization's strategic objectives.
- Reliability and integrity of financial and operational information.
- Effectiveness and efficiency of operations and programs.
- Safeguarding of assets.
- Compliance with laws, regulations, policies, procedures, and contracts.

2120.A2—The internal audit activity must evaluate the potential for the occurrence of fraud and how the organization manages fraud risk.

2120.C1—During consulting engagements, internal auditors must address risk consistent with the engagement’s objectives and be alert to the existence of other significant risks.

2120.C2—Internal auditors must incorporate knowledge of risks gained from consulting engagements into their evaluation of the organization’s risk management processes.

2120.C3—When assisting management in establishing or improving risk management processes, internal auditors must refrain from assuming any management responsibility by actually managing risks.

2130—CONTROL

The internal audit activity must assist the organization in maintaining effective controls by evaluating their effectiveness and efficiency and by promoting continuous improvement.

2130.A1—The internal audit activity must evaluate the adequacy and effectiveness of controls in responding to risks within the organization’s governance, operations, and information systems regarding the:

- Achievement of the organization’s strategic objectives.
- Reliability and integrity of financial and operational information.
- Effectiveness and efficiency of operations and programs.
- Safeguarding of assets.
- Compliance with laws, regulations, policies, procedures, and contracts.

2130.C1—Internal auditors must incorporate knowledge of controls gained from consulting engagements into evaluation of the organization’s control processes.

2200—ENGAGEMENT PLANNING

Internal auditors must develop and document a plan for each engagement, including the engagement’s objectives, scope, timing, and resource allocations. The plan must consider the organization’s strategies, objectives, and risks relevant to the engagement.

2201—PLANNING CONSIDERATIONS

In planning the engagement, internal auditors must consider:

- The strategies and objectives of the activity being reviewed and the means by which the activity controls its performance.
- The significant risks to the activity’s objectives, resources, and operations and the means by which the potential impact of risk is kept to an acceptable level.
- The adequacy and effectiveness of the activity’s governance, risk management, and control processes compared to a relevant framework or model.
- The opportunities for making significant improvements to the activity’s governance, risk management, and control processes.

2201.A1—When planning an engagement for parties outside the organization, internal auditors must establish a written understanding with them about objectives, scope, respective responsibilities, and other expectations, including restrictions on distribution of the results of the engagement and access to engagement records.

2201.C1—Internal auditors must establish an understanding with consulting engagement clients about objectives, scope, respective responsibilities, and other client expectations. For significant engagements, this understanding must be documented.

2210—ENGAGEMENT OBJECTIVES

Objectives must be established for each engagement.

2210.A1—Internal auditors must conduct a preliminary assessment of the risks relevant to the activity under review. Engagement objectives must reflect the results of this assessment.

2210.A2—Internal auditors must consider the probability of significant errors, fraud, noncompliance, and other exposures when developing the engagement objectives.

2210.A3—Adequate criteria are needed to evaluate governance, risk management, and controls. Internal auditors must ascertain the extent to which management and/or the board has established adequate criteria to determine whether objectives and goals have been accomplished. If adequate, internal auditors must use such criteria in their evaluation. If inadequate, internal auditors must identify appropriate evaluation criteria through discussion with management and/or the board.

Interpretation

Types of criteria may include:

- *Internal (e.g., policies and procedures of the organization).*
- *External (e.g., laws and regulations imposed by statutory bodies).*
- *Leading practices (e.g., industry and professional guidance).*

2210.C1—Consulting engagement objectives must address governance, risk management, and control processes to the extent agreed upon with the client.

2210.C2—Consulting engagement objectives must be consistent with the organization's values, strategies, and objectives.

2220—ENGAGEMENT SCOPE

The established scope must be sufficient to achieve the objectives of the engagement.

2220.A1—The scope of the engagement must include consideration of relevant systems, records, personnel, and physical properties, including those under the control of third parties.

2220.A2—If significant consulting opportunities arise during an assurance engagement, a specific written understanding as to the objectives, scope, respective responsibilities, and other expectations should be reached and the results of the consulting engagement communicated in accordance with consulting standards.

2220.C1—In performing consulting engagements, internal auditors must ensure that the scope of the engagement is sufficient to address the agreed-upon objectives. If internal auditors develop reservations about the scope during the engagement, these reservations must be discussed with the client to determine whether to continue with the engagement.

2220.C2—During consulting engagements, internal auditors must address controls consistent with the engagement's objectives and be alert to significant control issues.

2230—ENGAGEMENT RESOURCE ALLOCATION

Internal auditors must determine appropriate and sufficient resources to achieve engagement objectives based on an evaluation of the nature and complexity of each engagement, time constraints, and available resources.

Interpretation

Appropriate refers to the mix of knowledge, skills, and other competencies needed to perform the engagement. Sufficient refers to the quantity of resources needed to accomplish the engagement with due professional care.

2240—ENGAGEMENT WORK PROGRAM

Internal auditors must develop and document work programs that achieve the engagement objectives.

2240.A1—Work programs must include the procedures for identifying, analyzing, evaluating, and documenting information during the engagement. The work program must be approved prior to its implementation, and any adjustments approved promptly.

2240.C1—Work programs for consulting engagements may vary in form and content depending upon the nature of the engagement.

2300—PERFORMING THE ENGAGEMENT

Internal auditors must identify, analyze, evaluate, and document sufficient information to achieve the engagement's objectives.

2310—IDENTIFYING INFORMATION

Internal auditors must identify sufficient, reliable, relevant, and useful information to achieve the engagement's objectives.

Interpretation

Sufficient information is factual, adequate, and convincing so that a prudent, informed person would reach the same conclusions as the auditor. Reliable information is the best attainable information through the use of appropriate engagement techniques. Relevant information supports engagement observations and recommendations and is consistent with the objectives for the engagement. Useful information helps the organization meet its goals.

2320—ANALYSIS AND EVALUATION

Internal auditors must base conclusions and engagement results on appropriate analyses and evaluations.

2330—DOCUMENTING INFORMATION

Internal auditors must document sufficient, reliable, relevant, and useful information to support the engagement results and conclusions.

2330.A1—The chief audit executive must control access to engagement records. The chief audit executive must obtain the approval of senior management and/or legal counsel prior to releasing such records to external parties, as appropriate.

2330.A2—The chief audit executive must develop retention requirements for engagement records, regardless of the medium in which each record is stored. These retention requirements must be consistent with the organization's guidelines and any pertinent regulatory or other requirements.

2330.C1—The chief audit executive must develop policies governing the custody and retention of consulting engagement records, as well as their release to internal and external parties. These policies must be consistent with the organization's guidelines and any pertinent regulatory or other requirements.

2340—ENGAGEMENT SUPERVISION

Engagements must be properly supervised to ensure objectives are achieved, quality is assured, and staff is developed.

Interpretation

The extent of supervision required will depend on the proficiency and experience of internal auditors and the complexity of the engagement. The chief audit executive has overall

responsibility for supervising the engagement, whether performed by or for the internal audit activity, but may designate appropriately experienced members of the internal audit activity to perform the review. Appropriate evidence of supervision is documented and retained.

2400—COMMUNICATING RESULTS

Internal auditors must communicate the results of engagements.

2410—CRITERIA FOR COMMUNICATING

Communications must include the engagement's objectives and scope as well as applicable conclusions, recommendations, and action plans.

2410.A1—Final communication of engagement results must, where appropriate, contain the internal auditors' opinion and/or conclusions. When issued, an opinion or conclusion must take account of the expectations of senior management, the board, and other stakeholders and must be supported by sufficient, reliable, relevant, and useful information.

Interpretation

Opinions at the engagement level may be ratings, conclusions, or other descriptions of the results. Such an engagement may be in relation to controls around a specific process, risk, or business unit. The formulation of such opinions requires consideration of the engagement results and their significance.

2410.A2—Internal auditors are encouraged to acknowledge satisfactory performance in engagement communications.

2410.A3—When releasing engagement results to parties outside the organization, the communication must include limitations on distribution and use of the results.

2410.C1—Communication of the progress and results of consulting engagements will vary in form and content depending upon the nature of the engagement and the needs of the client.

2420—QUALITY OF COMMUNICATIONS

Communications must be accurate, objective, clear, concise, constructive, complete, and timely.

Interpretation

Accurate communications are free from errors and distortions and are faithful to the underlying facts. Objective communications are fair, impartial, and unbiased and are the result of a fair-minded and balanced assessment of all relevant facts and circumstances. Clear communications are easily understood and logical, avoiding unnecessary technical language and providing all significant and relevant information. Concise communications are to the point and avoid unnecessary elaboration, superfluous detail, redundancy, and wordiness. Constructive communications are helpful to the engagement client and the organization and lead to improvements where needed. Complete communications lack nothing that is essential to the target audience and include all significant and relevant information and observations to support recommendations and conclusions. Timely communications are opportune and expedient, depending on the significance of the issue, allowing management to take appropriate corrective action.

2421—ERRORS AND OMISSIONS

If a final communication contains a significant error or omission, the chief audit executive must communicate corrected information to all parties who received the original communication.

2430—USE OF “CONDUCTED IN CONFORMANCE WITH THE INTERNATIONAL STANDARDS FOR THE PROFESSIONAL PRACTICE OF INTERNAL AUDITING”

Indicating that engagements are “conducted in conformance with the *International Standards for the Professional Practice of Internal Auditing*” is appropriate only if supported by the results of the quality assurance and improvement program.

2431—ENGAGEMENT DISCLOSURE OF NONCONFORMANCE

When nonconformance with the Code of Ethics or the *Standards* impacts a specific engagement, communication of the results must disclose the:

- Principle(s) or rule(s) of conduct of the Code of Ethics or the Standard(s) with which full conformance was not achieved.
- Reason(s) for nonconformance.
- Impact of nonconformance on the engagement and the communicated engagement results.

2440—DISSEMINATING RESULTS

The chief audit executive must communicate results to the appropriate parties.

Interpretation

The chief audit executive is responsible for reviewing and approving the final engagement communication before issuance and for deciding to whom and how it will be disseminated. When the chief audit executive delegates these duties, he or she retains overall responsibility.

2440.A1—The chief audit executive is responsible for communicating the final results to parties who can ensure that the results are given due consideration.

2440.A2—If not otherwise mandated by legal, statutory, or regulatory requirements, prior to releasing results to parties outside the organization the chief audit executive must:

- Assess the potential risk to the organization.
- Consult with senior management and/or legal counsel as appropriate.
- Control dissemination by restricting the use of the results.

2440.C1—The chief audit executive is responsible for communicating the final results of consulting engagements to clients.

2440.C2—During consulting engagements, governance, risk management, and control issues may be identified. Whenever these issues are significant to the organization, they must be communicated to senior management and the board.

2450—OVERALL OPINIONS

When an overall opinion is issued, it must take into account the strategies, objectives, and risks of the organization; and the expectations of senior management, the board, and other stakeholders. The overall opinion must be supported by sufficient, reliable, relevant, and useful information.

Interpretation

The communication will include:

- *The scope, including the time period to which the opinion pertains.*
- *Scope limitations.*
- *Consideration of all related projects including the reliance on other assurance providers.*
- *A summary of the information that supports the opinion.*
- *The risk or control framework or other criteria used as a basis for the overall opinion.*
- *The overall opinion, judgment, or conclusion reached.*

The reasons for an unfavorable overall opinion must be stated.

2500—MONITORING PROGRESS

The chief audit executive must establish and maintain a system to monitor the disposition of results communicated to management.

2500.A1—The chief audit executive must establish a follow-up process to monitor and ensure that management actions have been effectively implemented or that senior management has accepted the risk of not taking action.

2500.C1—The internal audit activity must monitor the disposition of results of consulting engagements to the extent agreed upon with the client.

2600—COMMUNICATING THE ACCEPTANCE OF RISKS

When the chief audit executive concludes that management has accepted a level of risk that may be unacceptable to the organization, the chief audit executive must discuss the matter with senior management. If the chief audit executive determines that the matter has not been resolved, the chief audit executive must communicate the matter to the board.

Interpretation

The identification of risk accepted by management may be observed through an assurance or consulting engagement, monitoring progress on actions taken by management as a result of prior engagements, or other means. It is not the responsibility of the chief audit executive to resolve the risk.

Glossary

Add Value The internal audit activity adds value to the organization (and its stakeholders) when it provides objective and relevant assurance, and contributes to the effectiveness and efficiency of governance, risk management, and control processes.

Adequate Control Present if management has planned and organized (designed) in a manner that provides reasonable assurance that the organization's risks have been managed effectively and that the organization's goals and objectives will be achieved efficiently and economically.

Assurance Services An objective examination of evidence for the purpose of providing an independent assessment on governance, risk management, and control processes for the organization. Examples may include financial, performance, compliance, system security, and due diligence engagements.

Board The highest level governing body (e.g., a board of directors, a supervisory board, or a board of governors or trustees) charged with the responsibility to direct and/or oversee the organization's activities and hold senior management accountable. Although governance arrangements vary among jurisdictions and sectors, typically the board includes management. If a board does not exist, the word "board" in the *Standards* refers to a group or person charged with governance of the organization. Furthermore, "board" in the *Standards* may refer to a committee or another body to which the governing body has delegated certain functions (e.g., an audit committee).

Charter The internal audit charter is a formal document that defines the internal audit activity's purpose, authority, and responsibility. The internal audit charter establishes the internal audit activity's position within the organization; authorizes access to records, personnel, and physical properties relevant to the performance of engagements; and defines the scope of internal audit activities.

Chief Audit Executive Chief audit executive (CAE) describes the role of a person in a senior position responsible for effectively managing the internal audit activity in accordance with the internal audit charter and the mandatory elements of the International Professional Practices Framework. The chief audit executive or others reporting to the

chief audit executive will have appropriate professional certifications and qualifications. The specific job title and/or responsibilities of the chief audit executive may vary across organizations.

Code of Ethics The Code of Ethics of The Institute of Internal Auditors (IIA) are principles relevant to the profession and practice of internal auditing, and Rules of Conduct that describe behavior expected of internal auditors. The Code of Ethics applies to both parties and entities that provide internal audit services. The purpose of the Code of Ethics is to promote an ethical culture in the global profession of internal auditing.

Compliance Adherence to policies, plans, procedures, laws, regulations, contracts, or other requirements.

Conflict of Interest Any relationship that is, or appears to be, not in the best interest of the organization. A conflict of interest would prejudice an individual's ability to perform his or her duties and responsibilities objectively.

Consulting Services Advisory and related client service activities, the nature and scope of which are agreed with the client, are intended to add value and improve an organization's governance, risk management, and control processes without the internal auditor assuming management responsibility. Examples include counsel, advice, facilitation, and training.

Control Any action taken by management, the board, and other parties to manage risk and increase the likelihood that established objectives and goals will be achieved. Management plans, organizes, and directs the performance of sufficient actions to provide reasonable assurance that objectives and goals will be achieved.

Control Environment The attitude and actions of the board and management regarding the importance of control within the organization. The control environment provides the discipline and structure for the achievement of the primary objectives of the system of internal control. The control environment includes the following elements:

- Integrity and ethical values.
- Management's philosophy and operating style.
- Organizational structure.
- Assignment of authority and responsibility.
- Human resource policies and practices.
- Competence of personnel.

Control Processes The policies, procedures (both manual and automated), and activities that are part of a control framework, designed and operated to ensure that risks are contained within the level that an organization is willing to accept.

Core Principles for the Professional Practice of Internal Auditing The Core Principles for the Professional Practice of Internal Auditing are the foundation for the International Professional Practices Framework and support internal audit effectiveness.

Engagement A specific internal audit assignment, task, or review activity, such as an internal audit, control self-assessment review, fraud examination, or consultancy. An engagement may include multiple tasks or activities designed to accomplish a specific set of related objectives.

Engagement Objectives Broad statements developed by internal auditors that define intended engagement accomplishments.

Engagement Opinion The rating, conclusion, and/or other description of results of an individual internal audit engagement, relating to those aspects within the objectives and scope of the engagement.

Engagement Work Program A document that lists the procedures to be followed during an engagement, designed to achieve the engagement plan.

External Service Provider A person or firm outside of the organization that has special knowledge, skill, and experience in a particular discipline.

Fraud Any illegal act characterized by deceit, concealment, or violation of trust. These acts are not dependent upon the threat of violence or physical force. Frauds are perpetrated by parties and organizations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage.

Governance The combination of processes and structures implemented by the board to inform, direct, manage, and monitor the activities of the organization toward the achievement of its objectives.

Impairment Impairment to organizational independence and individual objectivity may include personal conflict of interest, scope limitations, restrictions on access to records, personnel, and properties, and resource limitations (funding).

Independence The freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner.

Information Technology Controls Controls that support business management and governance as well as provide general and technical controls over information technology infrastructures such as applications, information, infrastructure, and people.

Information Technology Governance Consists of the leadership, organizational structures, and processes that ensure that the enterprise's information technology supports the organization's strategies and objectives.

Internal Audit Activity A department, division, team of consultants, or other practitioner(s) that provides independent, objective assurance and consulting services designed to add value and improve an organization's operations. The internal audit activity helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of governance, risk management and control processes.

International Professional Practices Framework The conceptual framework that organizes the authoritative guidance promulgated by The IIA. Authoritative guidance is composed of two categories—(1) mandatory and (2) recommended.

Must The *Standards* use the word “must” to specify an unconditional requirement.

Objectivity An unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no quality compromises are made. Objectivity requires that internal auditors do not subordinate their judgment on audit matters to others.

Overall Opinion The rating, conclusion, and/or other description of results provided by the chief audit executive addressing, at a broad level, governance, risk management, and/or control processes of the organization. An overall opinion is the professional judgment of the chief audit executive based on the results of a number of individual engagements and other activities for a specific time interval.

Risk The possibility of an event occurring that will have an impact on the achievement of objectives. Risk is measured in terms of impact and likelihood.

Risk Appetite The level of risk that an organization is willing to accept.

Risk Management A process to identify, assess, manage, and control potential events or situations to provide reasonable assurance regarding the achievement of the organization's objectives.

Should The *Standards* use the word “should” where conformance is expected unless, when applying professional judgment, circumstances justify deviation.

Significance The relative importance of a matter within the context in which it is being considered, including quantitative and qualitative factors, such as magnitude, nature, effect, relevance, and impact. Professional judgment assists internal auditors when evaluating the significance of matters within the context of the relevant objectives.

Standard A professional pronouncement promulgated by the Internal Audit Standards Board that delineates the requirements for performing a broad range of internal audit activities and for evaluating internal audit performance.

Technology-Based Audit Techniques Any automated audit tool, such as generalized audit software, test data generators, computerized audit programs, specialized audit utilities, and computer-assisted audit techniques (CAATs).

Appendix

American Institute of Certified Public Accountants (AICPA) Codification of Statements on Auditing Standards*

AT-C Introduction

- Foreword
- Preface
- Glossary

AU-C 200–299 General Principles and Responsibilities

- 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards
- 210 Terms of Engagement
- 220 Quality Control for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards
- 230 Audit Documentation
- 240 Consideration of Fraud in a Financial Statement Audit
- 250 Consideration of Laws and Regulations in an Audit of Financial Statements
- 260 The Auditor’s Communication with Those Charged with Governance
- 265 Communicating Internal Control Related Matters Identified in an Audit

AU-C 300–499 Risk Assessment and Response to Assessed Risks

- 300 Planning an Audit
- 315 Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement
- 320 Materiality in Planning and Performing an Audit
- 330 Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained
- 402 Audit Considerations Relating to an Entity Using a Service Organization
- 450 Evaluation of Misstatements Identified During the Audit

AU-C 500–599 Audit Evidence

- 500 Audit Evidence
- 501 Audit Evidence—Specific Considerations for Selected Items
- 505 External Confirmations
- 510 Opening Balances—Initial Audit Engagements, Including Reaudit Engagements
- 520 Analytical Procedures
- 530 Audit Sampling
- 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures
- 550 Related Parties
- 560 Subsequent Events and Subsequently Discovered Facts
- 570 The Auditor’s Consideration of and Entity’s Ability to Continue as a Going Concern
- 580 Written Representations
- 585 Consideration of Omitted Procedures after the Report Release Date^{AICPA only}

AU-C 600–699 Using the Work of Others

- 600 Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors and Referred-to Auditors)
- 610 Using the Work of Internal Auditors
- 620 Using the Work of an Auditor’s Specialist

* Although both codifications present the same general topic, some section titles differ between the AICPA and those of the IFAC. Section titles presented here are those of the AICPA. Also, the international standards include a section 710, which differs from AICPA section 708. Those sections designated with ^{AICPA only} do not have an international corresponding section (including all parts of the 900 section).

AU-C 700–799 Audit Conclusions and Reporting

- 700 Forming an Opinion and Reporting on Financial Statements
- 701 Communicating Key Audit Matters in the Independent Auditor's Report
- 703 Forming an Opinion and Reporting on Financial Statements of Employee Benefit Plans Subject to ERISA
- 705 Modifications to the Opinion in the Independent Auditor's Report
- 706 Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report
- 708 Consistency of Financial Statements
- 720 The Auditor's Responsibilities Relating to Other Information Included in Annual Reports
- 725 Supplementary Information in Relation to the Financial Statements as a Whole
- 730 Required Supplementary Information

AU-C 800–899 Other Types of Reports

- 800 Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks
- 805 Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement
- 806 Reporting on Compliance with Aspects of Contractual Agreements or Regulatory Requirements in Connection with Audited Financial Statements
- 810 Engagements to Report on Summary Financial Statements

AU-C 900–999 Special Considerations in the United States

- 905 Alert That Restricts the Use of the Auditor's Written Communication
- 910 Financial Statements Prepared in Accordance with a Financial Reporting Framework Generally Accepted in Another Country
- 915 Reports on Application of Requirements of an Applicable Financial Reporting Framework
- 920 Letters for Underwriters and Certain Other Requesting Parties
- 925 Filings with the U.S. Securities and Exchange Commission Under the Securities Act of 1933
- 930 Interim Financial Information
- 935 Compliance Audits
- 940 An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements
- 945 Auditor Involvement With Exempt Offering Documents

American Institute of Certified Public Accountants (AICPA) Attestation, Accounting and Review, and Code of Professional Conduct Standards
Attestation Codified Section Numbers (AT-C)**AT-C Introduction**

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- Preface
- Glossary

AT-C 100–199 Common Concepts—Engagements Requiring Assertions

- 100 Common Concepts
- 105 Concepts Common to All Attestation Engagements

AT-C 200–299 Level of Service Standards

- 205 Assertion-Based Examination Engagements
- 206 Direct Examination Engagements

210	Review Engagements
215	Agreed-Upon Procedures Engagements
AT-C 300–399 Subject Matter Standards—Engagements Requiring Assertions	
305	Prospective Financial Information
310	Reporting on Pro Forma Financial Information
315	Compliance Attestation
320	Reporting on an Examination of Controls at a Service Organization Relevant to User Entities’ Internal Control Over Financial Reporting
395	Management’s Discussion and Analysis
Preparation, Compilation and Review Codified Section Numbers (AR-C)	
60	General Principles for Engagements Performed in Accordance with Statements on Standards for Accounting and Review Services
70	Preparation of Financial Statements
80	Compilation Engagements
90	Review of Financial Statements
100	Special Considerations—International Reporting Issues
120	Compilation of Pro Forma Financial Information (a remaining AR section)
AICPA Code of Professional Conduct (ET)	
0.000	Preface: Applicable to All Members
1.000	Part 1: Members in Public Practice
2.000	Part 2: Members in Business
3.000	Part 3: Other Members

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Public Company Accounting Oversight Board (PCAOB) Auditing Standards

General Auditing Standards

AS 1000 General Principles and Responsibilities

1001	Responsibilities and Functions of the Independent Auditor
1005	Independence
1010	Training and Proficiency of the Independent Auditor
1015	Due Professional Care in the Performance of Work

AS 1100 General Concepts

1101	Audit Risk
1105	Audit Evidence
1110	Relationship of Auditing Standards to Quality Control Standards

AS 1200 General Activities

1201	Supervision of the Audit Engagement
1205	Part of the Audit Performed by Other Independent Auditors
1206	Dividing Responsibility for the Audit with Another Accounting Firm
1210	Using the Work of an Auditor-Engaged Specialist
1215	Audit Documentation
1220	Engagement Quality Review

AS 1300 Auditor Communications

1301	Communications with Audit Committees
1305	Communications About Control Deficiencies in an Audit of Financial Statements

Audit Procedures**AS 2100 Audit Planning and Risk Assessment**

- 2101 Audit Planning
- 2105 Consideration of Materiality in Planning and Performing an Audit
- 2110 Identifying and Assessing Risks of Material Misstatement

AS 2200 Auditing Internal Control Over Financial Reporting

- 2201 An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements

AS 2300 Audit Procedures in Response to Risks—Nature, Timing, and Extent

- 2301 The Auditor's Responses to the Risks of Material Misstatement
- 2305 Substantive Analytical Procedures
- 2310 The Auditor's Use of Confirmation
- 2315 Audit Sampling

AS 2400 Audit Procedures for Specific Aspects of the Audit

- 2401 Consideration of Fraud in a Financial Statement Audit
- 2405 Illegal Acts by Clients
- 2410 Related Parties
- 2415 Consideration of an Entity's Ability to Continue as a Going Concern

AS 2500 Audit Procedures for Certain Accounts or Disclosures

- 2501 Auditing Accounting Estimates, Including Fair Value Measurements.
- 2505 Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments
- 2510 Auditing Inventories

AS 2600 Special Topics

- 2601 Consideration of an Entity's Use of a Service Organization
- 2605 Consideration of the Internal Audit Function
- 2610 Initial Audits—Communications Between Predecessor and Successor Auditors

AS 2700 Auditor's Responsibilities Regarding Supplemental and Other Information

- 2701 Auditing Supplemental Information Accompanying Audited Financial Statements
- 2705 Required Supplementary Information
- 2710 Other Information in Documents Containing Audited Financial Statements

AS 2800 Concluding Audit Procedures

- 2801 Subsequent Events
- 2805 Management Representations
- 2810 Evaluating Audit Results
- 2815 The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles"
- 2820 Evaluating Consistency of Financial Statements

AS 2900 Post-Audit Matters

- 2901 Consideration of Omitted Procedures After the Report Date
- 2905 Subsequent Discovery of Facts Existing at the Date of the Auditor's Report

Auditor Reporting**AS 3100 Reporting on Audits of Financial Statements**

- 3101 Reports on Audited Financial Statements
- 3105 Departures from Unqualified Opinions and Other Reporting Circumstances
- 3110 Dating of the Independent Auditor's Report

AS 3300 Other Reporting Topics

- 3305 Special Reports
- 3310 Special Reports on Regulated Companies
- 3315 Reporting on Condensed Financial Statements and Selected Financial Data
- 3320 Association with Financial Statements

Other Matters**AS 4000 Matters Relating to Filings Under Federal Securities Laws**

- 4101 Responsibilities Regarding Filings Under Federal Securities Statutes
- 4105 Reviews of Interim Financial Information

AS 5000 Reserved**AS 6000 Other Matters Associated with Audits**

- 6101 Letters for Underwriters and Certain Other Requesting Parties
- 6105 Reports on the Application of Accounting Principles
- 6110 Compliance Auditing Considerations in Audits of Recipients of Governmental Financial Assistance
- 6115 Reporting on Whether a Previously Reported Material Weakness Continues to Exist

Public Company Accounting Oversight Board (PCAOB) Attestation and Ethics Standards

Attestation Standards issued by PCAOB

- 1. Examination Engagements Regarding Compliance Reports of Brokers and Dealers
- 2. Review Engagements Regarding Exemption Reports of Brokers and Dealers

Interim Attestation Standards (AICPA Standards Adopted by PCAOB in April 2003; AT)

- 101 Attest Engagements
- 201 Agreed-Upon Procedures Engagements
- 301 Financial Forecasts and Projections
- 401 Reporting on Pro Forma Financial Information
- 601 Compliance Attestation
- 701 Management's Discussion and Analysis

PCAOB Ethics and Independence Rules, Quality Control Standards and Other Guidance

Available at pcaobus.org/standards

Government Auditing Standards

U.S. General Accounting Office, Yellow Book—www.gao.gov.

The Institute of Internal Auditors *Code of Ethics*

Introduction

The purpose of The Institute's *Code of Ethics* is to promote an ethical culture in the profession of internal auditing.

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

A code of ethics is necessary and appropriate for the profession of internal auditing, founded as it is on the trust placed in its objective assurance about risk management, control, and governance. The Institute's *Code of Ethics* extends beyond the definition of internal auditing to include two essential components:

1. Principles that are relevant to the profession and practice of internal auditing;
2. Rules of Conduct that describe behavior norms expected of internal auditors. These rules are an aid to interpreting the Principles into practical applications and are intended to guide the ethical conduct of internal auditors.

"Internal auditors" refers to Institute members, recipients of or candidates for IIA professional certifications, and those who provide internal auditing services within the definition of internal auditing.

Applicability and Enforcement

This *Code of Ethics* applies to both individuals and entities that provide internal auditing services. For IIA members and recipients of or candidates for IIA professional certifications, breaches of the *Code of Ethics* will be evaluated and administered according to The Institute's Bylaws and Administrative Directives. The fact that a particular conduct is not mentioned in the Rules of Conduct does not prevent it from being unacceptable or discreditable, and therefore, the member, certification holder, or candidate can be liable for disciplinary action.

Principles

Internal auditors are expected to apply and uphold the following principles:

Integrity

The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgment.

Objectivity

Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgments.

Confidentiality

Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.

Competency

Internal auditors apply the knowledge, skills, and experience needed in the performance of internal auditing services.

Rules of Conduct

1. Integrity

Internal auditors:

- 1.1. Shall perform their work with honesty, diligence, and responsibility.
- 1.2. Shall observe the law and make disclosures expected by the law and the profession.
- 1.3. Shall not knowingly be a party to any illegal activity, or engage in acts that are discreditable to the profession of internal auditing or to the organization.
- 1.4. Shall respect and contribute to the legitimate and ethical objectives of the organization.

2. Objectivity

Internal auditors:

- 2.1. Shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interests of the organization.
- 2.2. Shall not accept anything that may impair or be presumed to impair their professional judgment.
- 2.3. Shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review.

3. Confidentiality

Internal auditors:

- 3.1. Shall be prudent in the use and protection of information acquired in the course of their duties.
- 3.2. Shall not use information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organization.

4. Competency

Internal auditors:

- 4.1. Shall engage only in those services for which they have the necessary knowledge, skills, and experience.
- 4.2. Shall perform internal auditing services in accordance with the *Standards for the Professional Practice of Internal Auditing*.
- 4.3. Shall continually improve their proficiency and the effectiveness and quality of their services.*

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