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| **Welcome to Auditing and Attestation** |
|   | **Passing the Auditing/Attestation Part of the CPA Exam**Candidates sometimes have a misperception about the Auditing and Attestation part of the CPA examination, believing that auditing is primarily a practice-oriented part of the exam. They may believe that having had first-hand experience doing audit work is sufficient for success on this part, or that not having had such experience is insurmountable. Sometimes candidates have a false sense of security, expressing the view that "Auditing is just common sense!" However, their view often changes when they see the specificity of the CPA exam questions that focus on the relevant concepts and the applicable professional standards. Passing the auditing part of the CPA examination is fundamentally an academic endeavor. I believe that everything you need to pass is contained in CPAexcel -- all that is required is your commitment to carefully study it. |
|   | **AICPA Professional Standards**The Auditing and Attestation part of the CPA examination focuses heavily on candidates' familiarity with the applicable AICPA Professional Standards. Since the AICPA prepares the exam, it should not be surprising that they emphasize their professional literature. Indeed, a substantial majority of the points in auditing focuses on candidates' knowledge of the AICPA's Statements on Auditing Standards, the Statements on Standards for Attestation Engagements, the Statements on Standards for Accounting and Review Services, and, to a lesser extent, the Statements on Quality Control Standards. The entire set of AICPA Professional Standards tested in the Auditing and Attestation area have been outlined and are addressed. Of course, the PCAOB auditing standards and IFAC's International Standards on Auditing are "fair game" for testing and are also appropriately covered in CPAexcel. Fortunately, the AICPA's "clarified" auditing standards have now substantially reduced the significance of differences between the AICPA's Statements on Auditing Standards and the International Standards on Auditing. |
|   | **CPAexcel materials**These CPAexcel materials strive to achieve an optimal balance between **technical depth**, covering the topics on the AICPA Content Specification Outlines, and **efficiency**, focusing on the task at hand without excess verbiage and unnecessary detail. The materials emphasize the professional standards and important concepts that are the primary object of testing in the Auditing and Attestation area. I encourage you to review the study text basically in sequence, since auditing has something of a chronological order -- including planning, evidence gathering, and reporting. Read the study text carefully, and review the available supplemental outlines of the important AICPA Professional Standards, particularly for unfamiliar topics. And, very importantly, take the time to work on the proficiency questions and the multiple-choice questions that are integral to CPAexcel's successful approach. |
|   | **Multiple-choice questions**Even though the number of professional standards has increased over the years, these standards often deal with only incremental changes to similar prior standards. In many cases, the underlying concepts have not changed very much. This part of the exam is not quantitative by nature, so questions cannot be updated by simply changing the "numbers." If you make a diligent effort studying these past exams' multiple-choice questions, you will very likely see some "old friends" on your examination, or, at the very least, some questions that are very similar to what you have practiced. |
|   | **Final review**In addition to diligently studying the study text and the supplemental outlines of important professional standards and practicing proficiency questions and exam questions, candidates invariably benefit from an intensive final review. The study text is designed to facilitate an efficient review and I encourage you to spend a few days reviewing the study text to refresh your memory of important concepts immediately prior to testing. |
|   | Work hard and enjoy the accomplishment of becoming a CPA for the rest of your life! |
|   | *~ Prof. Donald Tidrick* |
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|   | In AUD, I am responsible for the 16%-20% of the CPA Exam that is devoted to Professional Responsibilities, including primarily the AICPA's Code of Professional Conduct, PCAOB and SEC ethics rules, GAO and DOL ethics guidelines, and the IFAC Code of Ethics for Professional Accountants. |
|   | Most of the attention in this part has always been upon the AICPA Code of Professional Conduct and I expect that to continue to be the case with the promulgation in summer 2014 of a new, electronic version of the Code. Most of the new Code goes into effect as of December 15, 2014. The "conceptual framework" portions go into effect December 15, 2015. The Code is now easily accessed at the AICPA website: http://pub.aicpa.org/codeofconduct/Ethics.aspx. It will be easily updated and is now organized along functional lines. Most of the Code addresses the attest work done by "Members in Public Practice." Some of the Code addresses the work done by "Members in Business," such as management accountants, internal auditors, accountants working for government agencies and NGOs, etc. A small portion of the Code addresses "Other Members," such as CPAs who are unemployed or retired. |
|   | The new version of the Code, which makes many substantive changes and huge organizational changes, more closely resembles the IFAC Code than before. Mastering the AICPA's Code of Professional Conduct will be very helpful to understanding the IFAC Code and the ethics code provisions of the Government Accountability Office (GAO) and the Department of Labor (DOL). |
|   | Remember that AICPA's tax-related ethics rules are located in the Regulation section. Many provisions of the Code covered here—such as those related to integrity, objectivity, advertising, and the like—apply to CPAs in all lines of endeavor—audit, tax, advisory services, etc. |
|   | The SEC and PCAOB material contained in this part deals primarily, though not exclusively, with additional Sarbanes-Oxley provisions aimed generally at improving the quality of financial information flowing to investors. Some of these are discussed inside our material on the AICPA Code.

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| **Accounting versus Auditing** |
| I. | **Financial Accounting**The accounting focuses primarily on the preparation and distribution of the general-purpose, historical financial statements (balance sheet, income statement, statement of cash flows, and statement of retained earnings), which are representations of management.

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| A. | These financial statements are distributed to interested parties outside of the reporting entity itself, such as actual or potential shareholders and creditors, major customers and suppliers, employees, regulators, and others for their decision-making (resource allocation) needs. |
| B. | Users' specific decision-making circumstances will involve different issues and they may have different information priorities and concerns, but most will want to evaluate whether management has performed well. |
| C. | Since management's performance will be evaluated, at least in part, by financial statements prepared by management itself, users need to know whether the financial statements are reliable when evaluating the performance of management. |

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| II. | **Auditing**The auditor's primary role is to provide an impartial (independent) report on the reliability of management's financial statements.

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| 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 the intended users can place in the financial statements."From the AICPA's Preface to *Codifications of Statements on Auditing Standards, Principles Underlying an Audit Conducted in Accordance with Generally Accepted Auditing Standards*. |

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| III. | **The Role of Standards**Think of "standards" as the criteria by which quality will be evaluated. The preparation of the financial statements and the performance of the audit are subject to very different standards.

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| A. | Standards applicable to evaluating the presentation of the financial statements

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| **Applicable financial reporting framework**"The financial reporting framework adopted by management and, where appropriate, those charged with governance in the preparation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation."**Financial reporting framework** "A set of criteria used to determine measurement, recognition, presentation, and disclosure of all material items appearing in the financial statements; for example: U.S. generally accepted accounting principles (GAAP), International Financial Reporting Standards (IFRSs), issued by the International Accounting Standards Board (IASB), or a special purpose framework." |
| 1. | The financial reporting framework adopted by an entity for its financial statement presentation in the U.S.A. may be based on IFRSs (issued by the IASB) or U.S. GAAP. |
| 2. | Accounting standards setters associated with U.S. GAAP -- The nature of the reporting entity determines which particular accounting standards must be followed under the label of U.S. GAAP.

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| a. | Federal governmental entities follow pronouncements of the Federal Accounting Standards Advisory Board (FASAB). |
| b. | State and local governmental entities follow pronouncements of the Governmental Accounting Standards Board (GASB). |
| c. | Other entities (such as corporations) follow pronouncements of the Financial Accounting Standards Board (FASB). |

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| B. | Standards applicable to evaluating the auditor's performance

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| 1. | **Outside of the U.S.A.**  --  "International Standards on Auditing" (ISAs) are issued by the International Auditing and Assurance Standards Board, an audit-related standard-setting body within the International Federation of Accountants, known as IFAC. |
| 2. | **Within the U.S.A.**  --  The nature of the reporting entity determines which auditing standards are applicable to an audit of the entity's financial statements.

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| a. | Governmental entities -- When required by law, regulation, or agreement, Generally Accepted Government Auditing Standards (GAGAS), issued by the U.S. Government Accountability Office (GAO) are applicable. |
| b. | Public companies (companies registered with the Securities and Exchange Commission, also referred to as "issuers," that is, issuers of securities to the public) -- the auditing standards of the Public Company Accounting Oversight Board (PCAOB) are applicable. |
| c. | Private companies (referred to as "nonissuers") and other entities -- the auditing standards of the AICPA's Auditing Standards Board are applicable; these pronouncements collectively are referred to by the AICPA as generally accepted auditing standards (GAAS). |

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| **AICPA's "clarity and convergence" project**The AICPA reissued substantially all of their existing Statements on Auditing Standards (SASs) in a clarified format intended to make the SASs easier to understand. In addition, the AICPA substantially converged their auditing standards to be consistent with the requirements of IFAC's International Standards on Auditing. Although some differences in those respective requirements remain (and will be covered elsewhere in CPAexcel), those standards are now very, very similar. The recent AICPA pronouncements are referred to as "Clarified Standards."The PCAOB adopted the then-existing AICPA auditing standards in April 2003 as "interim standards, on an initial, transitional basis." Since that time, the PCAOB has been issuing its own Auditing Standards. Much of the existing PCAOB auditing standards remain those of the AICPA existing as of April 16, 2003. |

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| **GAAS and Principles** |
| I. | **Generally Accepted Auditing Standards (GAAS)**Historically, the AICPA identified 10 standards comprising GAAS that used to serve as a framework for U.S. auditing standards. The AICPA replaced these 10 standards with 7 principles in connection with its Clarified Auditing Standards. (The AICPA no longer uses the term "GAAS" to refer to these 10 standards. Rather, the AICPA uses the term GAAS to refer to the body of professional standards issued in the form of Statements on Auditing Standards.) However, the PCAOB still incorporates the 10 traditional GAAS standards as a framework relevant to the PCAOB auditing standards. From a PCAOB perspective, there are 10 standards that comprise the traditional GAAS and that used to serve as the criteria to evaluate the quality of the auditor's performance.

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| https://app1.efficientlearning.com/pv4/cpaexcel/common/images/hint.gif**Note:**Remember the acronym **"TID-PIE-GCDO"** -- Training; Independence; Due care (general standards); Planning; Internal control; Evidence (field work standards); GAAP; Consistency; Disclosure; Opinion (reporting standards) -- A mnemonic for remembering the 10 standards of GAAS. The "key" words are part of the memory aid. The "standard" is the whole phrase that follows each of the key words. |
| A. | **General Standards**  --  There are 3 of these (**"TID"**). They are "personal" in nature as they relate to qualities that the auditor brings to the assignment:

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| 1. | **Training**  --  "The auditor must have adequate technical training and proficiency to perform the audit." |
| 2. | **Independence**  --  "The auditor must maintain independence in mental attitude in all matters relating to the audit." |
| 3. | **Due care**  --  "The auditor must exercise due professional care in the performance of the audit and the preparation of the report." |

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| B. | **Field Work Standards**  --  There are 3 of these (**"PIE"**). They are related to the evidence-gathering activities that form the foundation for the auditor's conclusions.

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| 1. | **Planning and supervision**  --  "The auditor must adequately plan the work and must properly supervise any assistants." |
| 2. | **Internal control**  --  "The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to fraud or error, and to design the nature, timing, and extent of further audit procedures." |
| 3. | **Evidence**  --  "The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit." |

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| C. | **Reporting Standards**  --  There are 4 of these (**"GCDO"**). Each of them says something about the language that is required in the auditor's report.

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| 1. | **GAAP**  --  "The auditor must state in the auditor's report whether the financial statements are presented in accordance with generally accepted accounting principles (GAAP)." |
| 2. | **Consistency**  --  "The auditor must identify in the auditor's report those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period." |
| 3. | **Disclosure**  --  "When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report." |
| 4. | **Opinion**  --  "The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that an opinion cannot be expressed, in the auditor's report. When the auditor cannot express an overall opinion, the auditor should state the reasons therefore in the auditor's report. In all cases where an auditor's name is associated with financial statements, the auditor should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking, in the auditor's report." |

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| II. | **Clarity and Convergence Project**In connection with its "clarity and convergence project" the AICPA has replaced its Statements on Auditing Standards to be similar to the International Standards on Auditing (ISAs) issued by the International Federation of Accountants (specifically IFAC's International Auditing & Assurance Standards Board, IAASB). As part of that effort, the AICPA has also replaced its use of 10 "Generally Accepted Auditing Standards" with 7 "principles" to provide a framework for understanding and explaining an audit.

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| A. | The 7 principles are not requirements and have no authoritative status. However, they are intended to be helpful as a framework for audit standard setting. |
| B. | The 7 principles reflect most of the considerations that had been addressed in the previous 10 generally accepted auditing standards (the former reporting standards seem to have changed the most relative to these principles). |
| C. | The 7 principles are organized around 4 primary themes -- (1) purpose/premise; (2) responsibilities; (3) performance; and (4) reporting (as a memory aid, remember: "PR-PR"). |

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| III. | **Purpose of an Audit and Premise Upon Which an Audit is Conducted**

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| A. | 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. |
| B. | An audit in accordance with generally accepted auditing standards is conducted on the premise that management and, where appropriate, those charged with governance, have responsibility for

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| 1. | 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; and |
| 2. | Providing 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; and unrestricted access to those within the entity from whom the auditor determines it necessary to obtain audit evidence. |

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| C. | **Responsibilities**  --  Note that the term *responsibilities principle* takes the place of what previously had been called General Standards describing characteristics the auditor brings to the engagement.

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| 1. | Auditors are responsible for having appropriate competence and capabilities to perform the audit; complying with relevant ethical requirements; and maintaining professional skepticism and exercising professional judgment, throughout the planning and performance of the audit. |

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| D. | **Performance**  --  Note that the term *performance principle* takes the place of what previously had been called Fieldwork Standards governing the auditor's evidence-gathering activities.

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| 1. | To express an opinion, the auditor obtains reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. |
| 2. | To obtain reasonable assurance, which is a high, but not absolute, level of assurance, the auditor

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| a. | Plans the work and properly supervises any assistants; |
| b. | Determines and applies appropriate materiality level or levels throughout the audit; |
| c. | 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; and |
| d. | Obtains sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks. |

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| 3. | The auditor is unable to obtain absolute assurance that the financial statements are free from material misstatement because of inherent limitations, which arise from

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| a. | The nature of financial reporting; |
| b. | The nature of audit procedures; and |
| c. | The need for the audit to be conducted within a reasonable period of time and so as to achieve a balance between benefit and cost. |

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| E. | **Reporting**  --

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| 1. | Based on an evaluation of the audit evidence obtained, the auditor expresses, in the form of a written report, an opinion in accordance with the auditor's findings, or states that an opinion cannot be expressed. The opinion states whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework. |

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| **Professional Standards** |
| I. | **The AICPA's Use of the Term *GAAS* and Guidance Associated with It**

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| A. | **Statements on Auditing Standards (SASs)**  --  The SASs constitute GAAS and must be followed by auditors when AICPA auditing standards are applicable. (Specifically, Rule 202, "Compliance With Standards," of the AICPA Code of Professional Conduct requires that auditors adhere to the standards promulgated by the Auditing Standards Board.) Under the clarified auditing standards, any reference to GAAS specifically means this body of professional standards (SASs) issued by the Auditing Standards Board.

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| 1. | The auditor is expected to have sufficient knowledge of the SASs to identify those applicable to the audit. |
| 2. | The auditor should be prepared to justify any departures from the SASs. |
| 3. | Materiality and audit risk also underlie the application of the SASs, particularly those related to performing the audit (evidence gathering) and reporting. |

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| B. | **"Interpretive publications"**  --  Consist of the appendices to the SASs, auditing interpretations of the SASs, auditing guidance included in AICPA Audit and Accounting Guides, and AICPA auditing Statements of Position.

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| 1. | Interpretive publications are **not** considered to be auditing standards, however. |
| 2. | These are issued under the authority of the Auditing Standards Board after all ASB members have had an opportunity to comment on the interpretive publication. |
| 3. | Auditors should be aware of (and consider) interpretive publications applicable to their audits. When auditors do not apply such auditing guidance, they should be prepared to explain how they complied with the SAS provisions related to such interpretive publications. |

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| C. | **"Other auditing publications"**  --  Include articles in the *Journal of Accountancy*and the AICPA's *CPA Letter* (and other professional publications), continuing professional education programs, textbooks, etc.

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| 1. | Other auditing publications have no authoritative status - they may be useful to the auditor in understanding and applying the SASs, however. |
| 2. | To assess the appropriateness of the other auditing publications - consider the degree to which the publication is recognized as helpful in applying the SASs and the degree to which the author is recognized as an authority on auditing matters. (Other auditing publications reviewed by the AICPA Audit and Attest Standards staff are presumed to be appropriate.) |

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| II. | **Categories of Professional Requirements**The various AICPA standards (i.e., Statements on Auditing Standards, Statements on Standards for Attestation Engagements, Statements on Standards for Accounting and Review Services, and Statements on Quality Control Standards) distinguish between **two types of professional requirements:**

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| A. | **"Unconditional requirements"**  --  Must comply with the requirement without exception (indicated by "must" in applicable standards); |
| B. | **"Presumptively mandatory requirements"**  --  In rare circumstances, the practitioner may depart from such a "requirement," but must document the justification for the departure and how the alternate procedures performed were adequate to meet the objective of the "requirement" (indicated by "should" in applicable standards). |

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**Quality Control Standards (SQCS)**I.**Relationship of GAAS to the SQCS**An individual audit engagement is governed by GAAS, whereas a CPA firm's collective portfolio of accounting and auditing services (sometimes called the "A&A" practice, which involves entities' financial statements and, thereby, involves the "public interest") is governed by the AICPA's SQCS. SQCS are issued by the AICPA's Auditing Standards Board (in particular, the section of the SQCS dealing with "A Firm's System of Quality Control" is QC10). The relevant AICPA guidance applicable to an individual audit engagement is provided by AU 220: "Quality Control for an Engagement Conducted in Accordance with [GAAS]."https://app1.efficientlearning.com/pv4/cpaexcel/common/images/note.gif**Note:**The purpose of AU 220 on "Quality Control for an Engagement Conducted in Accordance with [GAAS]" is to assist the auditor in implementing the firm's quality control procedures specifically at the engagement level. This pronouncement states that the auditor's objective is to implement quality control procedures at the engagement level that provide reasonable assurance that (a) the audit complies with professional standards and applicable legal and regulatory requirements and (b) the auditor issues an appropriate report.II.**Focus of the System of Quality Control**A CPA firm is required to have a "system of quality control" for its accounting and auditing services (covering audit, attestation, compilation, and review services; note that the SQCS are not applicable to tax or consulting services) to provide reasonable assurance that engagements are performed in accordance with professional standards and applicable regulatory and legal requirements, and that the issuance of reports are appropriate in the circumstances.

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| A. | **Nature and scope**  --  The policies and procedures will vary with the circumstances (e.g., firm size and number of offices, complexity of services offered, and the level of experience of the professional staff). |
| B. | **Inherent limitations**  --  Similar to any internal control system, a quality control system provides "reasonable" (a high, but not absolute) assurance, reflecting implicit cost-benefit trade-offs. |

III.**Six Elements of a Quality Control System**These are interrelated (e.g., monitoring and the quality of personnel involved affect the other elements).

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| A. | **Leadership responsibilities for quality**  --  Policies and procedures should promote an internal culture that emphasizes a commitment to quality (sometimes called the "tone at the top"). For an individual audit engagement, the engagement partner should take responsibility for overall audit quality, although performance of certain procedures may, of course, be delegated to other members of the engagement team. |
| B. | **Relevant ethical requirements**  --  Policies and procedures should address the independence of personnel as necessary (should obtain written confirmation of compliance with independence requirements from all appropriate personnel at least annually). |
| https://app1.efficientlearning.com/pv4/cpaexcel/common/images/note.gif**Note:**If the engagement team identifies a threat to independence that safeguards may not eliminate or reduce to an acceptable level, the engagement partner is required to report the matter to the relevant person(s) in the firm to determine the appropriate action (to either eliminate the threat or withdraw from the engagement when withdrawal is allowed under applicable law or regulation). |
| C. | **Acceptance and continuance of client-relationships and engagements**  --  Policies and procedures should carefully assess the risks associated with each engagement (including issues related to management integrity) and the firm should only undertake engagements that can be completed with professional competence. |
| D. | **Human resources**  --  Policies and procedures should address important personnel issues (including initial hiring, assignments to engagements, professional development and continuing professional education, and promotion decisions). |
| E. | **Engagement performance**  --  Policies and procedures should focus on compliance with all applicable firm and professional standards and applicable regulatory requirements, and encourage personnel to consult as necessary with professional (or other) literature or other human resources within or outside of the firm for appropriate guidance. |
| F. | **Monitoring**  --  Policies and procedures should provide an ongoing assessment of the adequacy of the design and the operating effectiveness of the system of quality control. Controls that are effective at one point in time, may deteriorate over time owing to neglect or changed circumstances. It is important that the controls are properly monitored so that timely adjustments can be made as necessary to keep the quality control policies and procedures working effectively over time. |

IV.**Differences of Opinion**The firm should establish policies and procedures for dealing with and resolving differences of opinion within the engagement team, with those consulted, and between the engagement partner and the engagement quality control reviewer (including that the conclusions reached are documented and implemented and that the report is not released until the matter is resolved).V.**Documentation of the Operation of Quality Control Policies and Procedures**The firm should establish policies and procedures requiring appropriate documentation of the operation of each element of the system of quality control.VI.**Definitions**

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| A. | **Engagement partner**  --  The person in the firm who is responsible for the audit engagement and its performance and for the auditor's report. |
| B. | **Engagement quality control review**  --  A process designed to provide an objective evaluation, before the report is released, of the significant judgments the engagement team made and the conclusions it reached in formulating the auditor's report. (The engagement quality control review process is only for those audit engagements, if any, for which the firm has determined that an engagement quality control review is required, in accordance with its policies and procedures.) |
| C. | **Engagement quality control reviewer**  --  This is the person in the firm, a suitably qualified external person, or a team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to objectively evaluate the significant judgments that the engagement team made and the conclusions it reached in formulating the auditor's report. |

VII.**The Main Difference Between the Clarified SAS and the Corresponding International Standard on Auditing**The SAS requires that the quality control review must be completed before the engagement partner **releases** the auditor's report, whereas the ISA requires that the quality control review be completed before the engagement partner **dates** the auditor's report.

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| **Overview of the Audit Process** |
| I. | **Engagement Planning**

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| A. | Decide whether to accept (or continue) the engagement - Recall the quality control standards regarding client acceptance/continuation issues. |
| B. | Perform risk assessment procedures to address the risks of material misstatement, whether due to error or fraud. |
| C. | Evaluate requirements for staffing and supervision. |
| D. | Prepare the required written audit plan (sometimes called the *audit program*) that specifies the nature, timing, and extent of auditing procedures for every audit area (which is usually prepared after control risk has been assessed, so that detection risk can be appropriately set in each audit area). |

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| II. | **Internal Control Considerations**

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| A. | Obtain an understanding of internal control for planning purposes as required, emphasizing the assessment of the risk of material misstatement in individual audit areas and document the understanding of internal control. |
| B. | If contemplating "reliance" on certain identified internal control strengths as a basis for reducing substantive testing, the auditor must then perform appropriate "tests of control" to determine that those specific controls are operating effectively, that is, working as intended. |

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| III. | **Substantive Audit Procedures (evidence gathering procedures whose purpose is to detect material misstatements, if there are any)**Note that the word *substantive* is derived from *substantiate*, which means "to verify." These are evidence-gathering procedures designed to verify the financial statement elements and to detect any material misstatements.

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| A. | **Analytical procedures**  --  Those evidence-gathering procedures that suggest "reasonableness" (or "unreasonableness") based upon a comparison to appropriate expectations or benchmarks, such as prior year's financial statements, comparability to industry data ( including ratios) or other interrelationships involving financial and/or nonfinancial data. |
| B. | **Tests of details**  --  Those evidence-gathering procedures consisting of either of two types:

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| 1. | **Tests of ending balances**  --  Where the final balance is assessed by testing the composition of the year-end balance (e.g., testing a sample of individual customers' account balances that make up the general ledger accounts receivable control account balance). |
| 2. | **Tests of transactions**  --  Where the final balance is assessed by examining those debits and credits that caused the balance to change from last year's audited balance to the current year's balance. |

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| IV. | **Reporting**Conclusions are expressed in writing using standardized language to avoid miscommunication. |
| **Overview of Auditor's Report** |
| I. | Prior to the issuance of the Clarified Standards, the so-called standard unqualified audit report under AICPA Professional Standards consisted of 3 paragraphs (comprised of a total of 9 sentences). The change in the audit reporting language is one of the major differences caused by the Clarified Standards.

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| A. | **Introductory Paragraph**  --  3 sentences:

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| 1. | Identify the entity's financial statements; |
| 2. | Identify management's responsibilities; and |
| 3. | Identify the auditor's responsibilities. |

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| B. | **Scope Paragraph**  --  5 sentences:

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| 1. | Audit conducted in accordance with GAAS; |
| 2. | Audit provides reasonable assurance; |
| 3. | Audit examines evidence on a test basis; |
| 4. | Audit includes assessing accounting principles used and significant estimates made; |
| 5. | Audit provides a reasonable basis for the opinion. |

 |
| C. | **Opinion Paragraph**  --  1 long sentence:

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| 1. | Express an opinion that the financial statements are fairly stated in conformity with GAAP (or other applicable accounting framework). |

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| A sample unqualified audit report under the "old" (now superseded) standards is provided below, so that the differences relative to the sample unqualified audit report under the "new" Clarified Standards will be more clearly recognized. |
| **Standard Unqualified Auditor's Report -- Under the "old" AICPA Professional Standards**Independent Auditor's ReportWe have audited the balance sheets of ABC Company at December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company at December 31, 20X2 and 20X1, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America./s/ CPA firm (signed by audit engagement partner)Date (The auditor's report should not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion.) |

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| II. | **Auditor's Report**Under the AICPA's Clarified Standards, the auditor's report has been reformatted and expanded to reflect 4 main sections:

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| A. | The first section has no label, but it identifies the nature of the engagement and the entity's financial statements involved (consists of 1 sentence). |
| B. | The second section is labeled "**Management's Responsibility for the Financial Statement**s" -- (1 sentence) it states that management is responsible for the fair presentation of the financial statements and the implementation of internal control. |
| C. | The third section is labeled "**Auditor's Responsibility**," which consists of 3 separate paragraphs.

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| 1. | The first consists of 3 sentences

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| a. | Responsibility to express an opinion; |
| b. | Conducted the audit in accordance with (GAAS); and |
| c. | Plan and perform the audit to provide reasonable assurance. |

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| 2. | The second consists of 5 sentences

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| a. | Perform procedures to obtain audit evidence about the amounts and disclosures; |
| b. | The procedures depend on the auditor's judgment, including assessment of risks of material misstatement, whether due to fraud or error; |
| c. | In making those risk assessments, the auditor considers internal control; |
| d. | The auditor expresses no such opinion (*on internal control, when not engaged to report on internal control in an "integrated audit"*); and |
| e. | An audit includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates. |

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| 3. | The third consists of 1 sentence -- expressing the auditor's belief that the audit evidence is sufficient and appropriate to provide a basis for the opinion. |

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| D. | The fourth section is labeled "**Opinion**" -- (1 sentence) it expresses the auditor's opinion (in the same wording as that used in the previous AICPA standards). |
| In the Clarified Standards, the AICPA has replaced the term *unqualified* with*unmodified*. Two versions of the sample unmodified auditor's report are provided below. The first presents the typical unmodified audit report in paragraph form; and the second presents it on a sentence-by-sentence basis for ease of review. |
| **Sample Unmodified Auditor's Report Under AICPA Clarified Standards**Independent Auditor's Report[Appropriate Addressee]We have audited the accompanying consolidated financial statements of ABC Company and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 20X1 and 20X0, and the related consolidated statements of income, changes in stockholders' equity and cash flows for the years then ended, and the related notes to the financial statements.**Management's Responsibility for the Financial Statements**Management is responsible for the preparation and fair presentation of these consolidated 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 consolidated financial statements that are free from material misstatement, whether due to fraud or error.**Auditor's Responsibility**Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether owing to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.**Opinion**In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Company and its subsidiaries as of December 31, 20X1 and 20X0, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.[Auditor's signature -- firm name, signed by audit engagement partner][**Auditor's city and state** -- this is a new requirement under the Clarified Standards][Date of the auditor's report -- when the auditor has obtained sufficient appropriate audit evidence as a reasonable basis for the opinion ] |
| **Sample Unmodified Auditor's Report Under AICPA Clarified Standards (Sentence-By-Sentence):**Independent Auditor's Report*[Introductory Paragraph]*1. We have audited the accompanying consolidated financial statements of ABC Company and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 20X1 and 20X0, and the related consolidated statements of income, changes in stockholders' equity and cash flows for the years then ended, and the related notes to the financial statements.**Management's Responsibility for the Financial Statements**1. Management is responsible for the preparation and fair presentation of these consolidated 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 consolidated financial statements that are free from material misstatement, whether owing to fraud or error.**Auditor's Responsibility***[First of 3 paragraphs]*1. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.2. We conducted our audits in accordance with auditing standards generally accepted in the United States of America.3. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.*[Second of 3 paragraphs]*4. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements.5. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether owing to fraud or error.6. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.7. Accordingly, we express no such opinion.8. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.*[Third of 3 paragraphs]*9. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.**Opinion**1. In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Company and its subsidiaries as of December 31, 20X1 and 20X0, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America. |

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| **Different Types of Engagements** |
| I. | **AICPA's Statements on Standards for Accounting and Review Services (SSARSs)**These are applicable when the CPA is associated with the financial statements of a private company, but that association is something less than a full-scope "audit" engagement.

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| A. | **Compilation**  --  This occurs when the CPA is engaged simply to assemble into financial statement format the financial records of a private company, without expressing any degree of assurance on the reliability of those financial statements. |
| B. | **Review**  --  This occurs when the CPA is engaged to provide a lower level of assurance (relative to that of an audit) on financial statements of a private company by performing limited procedures, including reading the financial statements, performing analytical procedures, and making appropriate inquiries of client personnel. |

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| II. | **AICPA's Statements on Standards for Attestation Engagements (SSAEs)**These are applicable when the CPA provides assurance about written representations or subject matter other than historical financial statements (e.g., management may make representations about its superior product performance that may be made more reliable by the CPA's independent verification and report). |
| III. | **Responsibilities Vary for Different Types of Engagements**

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| A. | **Understanding with the client**  --  When associated with financial statement subject matter, AICPA Professional Standards require the CPA to establish an understanding with the entity involved as to the services to be rendered and the parties' respective responsibilities. The CPA must document that understanding in a written engagement letter between the CPA and the client entity. This should not be surprising, since the "public interest" is associated with such financial statement subject matter. |
| https://app1.efficientlearning.com/pv4/cpaexcel/common/images/note.gif**Note:**A written engagement letter must be obtained for engagements to audit, review, or compile an entity's financial statements under AICPA Professional Standards. |
| B. | **Levels of assurance**  --  The level of assurance varies with the type of service involved and should be clearly addressed in the engagement letter between the CPA and the client entity.

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| 1. | **Audit**  --  An audit conveys a high level of assurance about the reliability of the financial statements, and is expressed as positive assurance in the form of an opinion (recall that the SASs apply to audits of "nonissuers"). |
| 2. | **Review**  --  A review conveys a lower (i.e., "moderate") level of assurance about financial statements (for a private company under the AICPA's SSARSs). |
| 3. | **Compilation**  --  A compilation conveys no assurance about the reliability of the financial statements (for a private company under the AICPA's SSARSs). |

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| C. | **Other attest engagements**  --  The CPA may convey either a high or moderate level of assurance about nonfinancial statement representations under the SSAEs. (The subject matter of the engagement involves something other than historical financial statements, and, hence, more flexibility exists to negotiate with the entity about the level of assurance to be conveyed and/or the procedures to be used as a basis for conclusions.) |
| https://app1.efficientlearning.com/pv4/cpaexcel/common/images/note.gif**Note:**The SSARSs and SSAEs will be explored in detail at an appropriate point later in the course materials. They are merely introduced here so that candidates will be reminded early on that the AICPA Professional Standards encompass a variety of types of standards governing different services associated with the CPA profession. |

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| **Pre-Engagement Planning Issues** |
| I. | **Statements on Quality Control Standards**Recall the AICPA's "Statements on Quality Control Standards (SQCS)" that are applicable to a CPA's financial statement related services.

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| A. | One of the six elements of a quality control system is "acceptance and continuance of clients and engagements." Auditors should avoid clients whose management lacks integrity or clients who are viewed as too risky owing to industry considerations or entity-specific issues. |
| B. | The auditor should also evaluate the compliance with applicable ethics requirements, especially regarding independence issues and competencies to properly perform the engagement, before proceeding with other significant audit-related activities. |

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| https://app1.efficientlearning.com/pv4/cpaexcel/common/images/question.gif**Question:**What if the successor believes that the financial statements covered by the predecessor's report require revision?**Answer:**Try to arrange a meeting with the three parties (i.e., the successor, predecessor, and client management) -- if the client refuses to meet to discuss issues reflecting on the appropriateness of the previously issued financial statements, the successor should consider the risks of being the entity's auditor. |
| https://app1.efficientlearning.com/pv4/cpaexcel/common/images/question.gif**Question:**What if the auditor is unable to observe the beginning inventory?**Answer:**If unable to verify the beginning inventory, the auditor may be unable to reach a conclusion about the cost of goods sold and, hence, the net income. As a result, the auditor may not be able to express an opinion on the fairness of the income statement, statement of cash flows, or statement of retained earnings. However, the auditor could still express an opinion on the balance sheet itself. |
| II. | **"Terms of Engagement"**The relevant AICPA guidance is provided by AU 210: "Terms of Engagement." This pronouncement addresses the auditor's responsibilities in agreeing upon the terms of the audit engagement with management (and those charged with governance, when appropriate).

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| A. | Auditor's objective under AU 210 -- The auditor's objective is to accept an audit engagement involving a new or existing audit client only when the basis for the audit has been agreed upon by (1) establishing when the "preconditions for an audit" are present; and (2) confirming that a common understanding of the terms of the engagement exists between the auditor and management (and those charged with governance, as applicable).

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| **Definition** *Preconditions for an audit* : The use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management to the premise on which an audit is conducted. |
| 1. | Management should acknowledge its responsibility for (a) the fair presentation of the financial statements; (b) the design and implementation of effective internal control over financial reporting; and (c) providing the auditor with all information relevant to the financial statements and any additional information requested by the auditor, and providing access to all entity personnel relevant to the audit of the financial statements. (The auditor should determine whether the financial reporting framework is appropriate and obtain an agreement that management acknowledges and understands its responsibilities.) |
| 2. | If the preconditions are not present -- the auditor should not accept the engagement; instead, the auditor should discuss the matter with management. |
| 3. | If management imposes a limitation on the scope of the audit that the auditor believes would result in a disclaimer of opinion (called a "limited engagement") -- the auditor normally should not accept the engagement. If such an entity is required by law or regulation to have an audit, the auditor is then allowed to accept the "limited engagement," so as long as a disclaimer of opinion is acceptable under the applicable law or regulation. |
| 4. | Agreement on audit engagement terms -- The agreement of the terms of the engagement should be documented in an audit "engagement letter" and address the following:

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| a. | The objective and scope of the audit; |
| b. | The auditor's responsibilities; |
| c. | Management's responsibilities; |
| d. | A statement about the inherent limitations of an audit; |
| e. | A statement identifying the applicable financial reporting framework; |
| f. | Reference to the expected content of any reports to be issued; and |
| g. | Other matters as warranted in the auditor's judgment. |

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| B. | **Initial audits**  --  *Initial audit* refers to when the prior year's financial statements have been audited by a different auditor (referred to as the "predecessor auditor").

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| 1. | Before accepting the engagement -- The auditor should request that management authorize the predecessor auditor to respond to the auditor's inquiries relevant to the decision whether to accept the engagement. |
| 2. | The predecessor is expected to respond fully and to indicate when the response is limited. The auditor should evaluate the predecessor's response in deciding whether to accept the engagement. If management does not authorize the predecessor to respond (or otherwise limits the predecessor's response), the auditor should consider that fact in deciding whether to accept the engagement. |
| 3. | The auditor's communication with the predecessor auditor may be written or verbal -- typical matters expected to be addressed include the following:

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| a. | Information that might bear on the integrity of management; |
| b. | Any disagreements with management about accounting or auditing issues; |
| c. | Communications involving those charged with governance with respect to fraud and/or noncompliance with applicable laws or regulations; |
| d. | Communications involving management and those charged with governance regarding significant deficiencies in internal control; and |
| e. | The predecessor's understanding about the reasons for the entity's change in auditors. |

 |
| https://app1.efficientlearning.com/pv4/cpaexcel/common/images/question.gif**Question:**What if the auditor believes that the financial statements covered by the predecessor's report require revision?**Answer:**Try to arrange a 3-way meeting involving the auditor, predecessor, and entity management. If management refuses to meet to discuss issues related to the appropriateness of previously issued financial statements, the auditor should consider those matters in deciding whether to accept the engagement. |

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| C. | **Recurring audit engagements**  --  If the auditor concludes that the terms of the preceding engagement are still applicable to the current engagement, the auditor should remind management of the terms of the engagement (and document that reminder).

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| 1. | The auditor may remind management of the terms of the engagement in writing or verbally. When the communication is oral, it is desirable to document the significant matters discussed (including with whom and when). |
| 2. | It may be appropriate to revise the terms of the previous engagement --This is the case, for example, when there is a change in senior management or a significant change in ownership; when there is a change in the financial reporting framework adopted; when there is a change in legal or regulatory requirements; when there is any indication that management misunderstands the nature of the audit; or when there are special terms to the engagement. |

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| D. | Acceptance of a change in the terms of the audit engagement

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| 1. | If the auditor is asked to change the audit engagement to an engagement resulting in a lower level of assurance (prior to completing the audit engagement) -- The auditor should determine whether reasonable justification for doing so exists; if not, the auditor should decline the request. |
| 2. | Suppose that the auditor concludes no reasonable justification for such a change exists, but management will not permit the auditor to continue the original audit engagement. The auditor should: (a) withdraw from the audit engagement when possible; (b) communicate the circumstances to those charged with governance; and (c) determine whether there is any legal or other obligation to report the matter to any other parties. |
| 3. | Reasonable basis for a change -- Reasonable justification would exist when there is a change in circumstances affecting management's requirements, or if there was a misunderstanding about the nature of the service originally requested. The resulting report should not refer to any audit procedures performed prior to changing the engagement to a review or other service. |

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| III. | **Sample Engagement Letter**

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| **CPA Firm's Letterhead**(Date)

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| Ms. Nancy Pritchett\* |
| ABC Company\*\* |
| 1803 King Avenue |
| Columbus, OH 43212 |

Dear Ms. Pritchett:This letter confirms our understanding of the services we will provide to ABC Company for the fiscal year ended December 31, 20XX. Moreover, this letter constitutes the entire agreement between us regarding the services covered by this letter, and it supersedes any prior proposals, correspondence, and understandings, whether written or oral.Services and Related ReportWe will audit the balance sheet of ABC Company as of December 21, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended, for the purpose of expressing an opinion on them. Upon completion of our audit, we will provide you with our audit report on those financial statements.Our Responsibilities and LimitationsOur responsibility is to express an opinion on the financial statements based on our audit, and is limited to the period covered by our audit. If circumstances preclude us from issuing an unqualified opinion, we will discuss the reasons with you in advance. If, for any reason, we are unable to complete the audit or are unable to form an opinion, we may decline to express an opinion or decline to issue a report for the engagement.We are responsible for conducting the audit in accordance with generally accepted auditing standards. Those standards require that we obtain reasonable, but not absolute, assurance about whether the financial statements are free of errors or fraud that would have a material effect on the financial statements, as well as other illegal acts having a direct and material effect on the financial statements. Accordingly, a material misstatement may remain undetected. An audit is not designed to detect errors, fraud, or the effects of illegal acts that might be immaterial to the financial statements. We will inform you of all matters of fraud that come to our attention. We will also inform you of any illegal acts that come to our attention, unless they are clearly inconsequential.We will obtain an understanding of internal control over financial reporting sufficient to properly plan the audit and to determine the nature, timing, and extent of audit procedures to be performed. The audit will not be designed to provide assurance on internal control over financial reporting or to detect significant deficiencies in internal control. However, we will report to you any significant deficiencies in internal control that we identify.An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Judgment is required in determining the areas and number of transactions selected for our testing. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. Our procedures will include appropriate tests of documentary evidence supporting the transactions recorded in the accounts, tests of the physical existence of inventory, and direct confirmation of accounts receivable and certain other assets and liabilities by correspondence with selected customers, banks, legal counsel, and creditors. At the conclusion of our audit, we will request certain written representations from senior management about the financial statements and related matters.Management's ResponsibilitiesThe financial statements are the responsibility of the Company's management. That responsibility includes properly recording transactions in the accounting records and establishing and maintaining internal control sufficient to permit the preparation of financial statements in conformity with generally accepted accounting principles.The Company's management is responsible for adjusting the financial statements to correct any material misstatements and for affirming to us in the representation letter that the effects of any uncorrected misstatements aggregated by us during the engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. Management is also responsible for ensuring that the Company complies with all applicable laws and regulations.The Company's management is also responsible for making available to us, on a timely basis, all of the Company's original accounting records and related information, documentation, and company personnel to whom we may direct our inquiries. That includes providing access to us to the minutes of all meetings of stockholders, the board of directors, and committees of the board of directors for which such minutes are taken.Timing, Fees, and Other MattersAssistance to be supplied by the Company's personnel, including the preparation of certain specific schedules and analyses of accounts, is described in a separate attachment. Timely completion of this work is necessary for us to complete our audit on a timely basis.The results of our audit tests, the responses to our inquiries, and the written representation furnished by management, comprise the evidence that we will reply upon in forming our opinion on the financial statements. The resulting audit documentation for this engagement is the property of (*name of the CPA firm*) and access will be limited to authorized persons to protect the confidentiality of company-specific information.As part of our engagement for the year ending December 31, 20XX, we will review the federal and state income tax returns for ABC Company. We will be available during the year to consult with you on the tax effects of any proposed transactions or anticipated changes in your business activities.Our fees will be billed as work progresses and are based on the amount of time required plus out-of-pocket expenses incurred by our audit team. Individual hourly rates vary according to the degree of responsibility involved and the experience and skill required. We will notify you on a timely basis of any circumstances we encounter that might affect our initial estimate of total fees, which we anticipate will range from $xx,xxx to $xx,xxx, excluding the aforementioned out-of-pocket expenses. Invoices are payable upon presentation.If this letter accurately reflects your understanding, please sign where indicated in the space provided below and return it to us. We appreciate the opportunity to serve you and look forward to a mutually enjoyable association.Sincerely yours,(Name of the CPA Firm)\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_Engagement Partner's SignatureAccepted and agreed to:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_(ABC Company Representative's Signature)(Title)(Date)\*The engagement letter should be addressed to whoever engaged the CPA firm (which might be the entity's CEO, board of directors, or someone else). The client representative responsible for the engagement who signs the engagement letter should be given a copy of the signed engagement letter and the CPA firm should retain the original letter for engagement documentation purposes.\*\*Assume that ABC Company is a "nonissuer" (i.e., a private company) such that PCAOB auditing standards do not apply. Hence, there is no mention here of PCAOB auditing standards or the audit of internal control that is applicable to SEC registrants under the Sarbanes-Oxley Act of 2002. |

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| **Planning an Audit** |
| Recall the AICPA's specific "Performance Principle" dealing with "planning, materiality, risk assessment, and evidence," which states: "To obtain reasonable assurance, which is a high, but not absolute, level of assurance, the auditor: plans the work and properly supervises any assistants."For PCAOB auditing standards, recall the First Field-work Standard of GAAS "The auditor must adequately plan the work and must properly supervise any assistants." |
| I. | **AICPA Guidance**The relevant AICPA guidance is provided by AU 300: "Planning An Audit." This pronouncement states that the auditor's objective is to plan the audit so that it will be performed in an effective manner.

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| A. | Involvement of key engagement team members -- The engagement partner and other key members of the audit team should be involved in planning activities.

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| 1. | The nature and extent of planning varies with the size and complexity of the entity, the audit team's experience with the entity, and changes in circumstances occurring during the engagement. Likewise, the extent of supervision and review can vary depending upon the size and complexity of the entity, the nature of the audit area involved, the assessed risks of material misstatement, and the competence of the audit personnel involved. |
| 2. | Planning is an ongoing iterative process, not a one-time activity. Planning encompasses risk assessment procedures, understanding the applicable legal and regulatory framework, the determination of materiality, the involvement of specialists, and so forth. |
| 3. | The engagement partner may delegate portions of planning and supervision to other personnel, but a discussion about the risk of material misstatement (including fraud risks) among key members of the audit team, including the engagement partner, is required. |

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| B. | Preliminary engagement activities -- The auditor should address the following matters at the beginning of the engagement:

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| 1. | Perform appropriate procedures to address quality control issues related to the continuance of the client relationship and the specific audit engagement (including consideration of issues regarding management integrity); |
| 2. | Evaluate compliance with relevant ethical requirements related to quality control considerations (particularly regarding independence issues); |
| 3. | Establish an understanding of the terms of the engagement. |

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| C. | **Planning activities**  --

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| 1. | The auditor should establish an "overall audit strategy" dealing with the scope and timing of the audit work, which affects the development of the required "audit plan." (An audit plan is more detailed than the overall strategy and deals with the nature, timing, and extent of audit procedures to be performed.) In establishing the overall audit strategy, the auditor should:

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| a. | Identify relevant characteristics of the engagement affecting its scope; |
| b. | Identify the reporting objectives of the engagement and required communications; |
| c. | Consider the factors that are significant in utilizing the audit team; |
| d. | Consider the results of preliminary engagement activities, and |
| e. | Determine the nature, timing, and extent of necessary resources for the engagement. |
| f. | The overall strategy affects the auditor's decisions regarding the allocation of audit resources to specific audit areas and how those resources are managed and supervised. |
| g. | Communication with those charged with governance -- The auditor is required to communicate with those charged with governance about an overview of the planned scope and timing of the engagement. The auditor may discuss planning issues with management, but should be careful to avoid divulging details that might reduce the effectiveness of the audit by making the auditor's procedures and scope too predictable. |

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| 2. | The auditor should also develop an "audit plan." (In practice, the term "audit program" is often used in place of what the AICPA calls the "audit plan.") The audit plan encompasses (a) the nature and extent of planned risk assessment procedures; (b) the nature, timing, and extent of planned "further audit procedures" at the relevant assertion level; and (c) other planned audit procedures necessary to comply with GAAS. Note: Because planning is an iterative process, the auditor should make appropriate changes to the overall strategy and to the audit plan as necessary during the course of the audit if unexpected circumstances are encountered. |

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| D. | Specialized skills -- The auditor should determine whether there is a need for specialized skills on the engagement. In the past, the AICPA used the term*specialist* to describe what they now call "a professional possessing specialized skills."

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| 1. | A professional having specialized skills may be someone within or outside of the audit firm. Examples include valuation experts, appraisers, actuaries, tax specialists, IT professionals, etcetera. |
| 2. | The auditor should be sufficiently knowledgeable about the matters involved to communicate the objectives of the work, to evaluate whether the planned procedures will meet the auditor's needs, and to evaluate the results of the procedures performed. |

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| E. | Documentation -- The auditor should address the following matters in the audit documentation: (1) the overall audit strategy; (2) the audit plan; and (3) any significant changes made to the audit strategy or the audit plan during the audit engagement, along with the reasons for any such changes. |

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| II. | **PCAOB Standards**The relevant PCAOB guidance is provided by Auditing Standard No. 9, "Audit Planning." The auditor's planning-related responsibilities are virtually the same under the PCAOB standards as they are under the AICPA standards. |
| **Materiality** |
| I. | **AICPA Guidance**The relevant AICPA guidance is provided by AU 320: "Materiality in Planning and Performing An Audit." This pronouncement states that the auditor's objective is to apply the concept of materiality appropriately in planning and performing the audit. |
| II. | **"Materiality"**The concept of materiality can be described as "an understanding of what is important" in financial reporting based on the auditor's perception of the users' needs.

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| A. | A definition of "materiality:" from the FASB's Conceptual Framework project (specifically, Statement on Financial Accounting Concepts No. 2) follows:

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| "The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement." (Note that this definition emphasizes that materiality judgments involve both quantitative and qualitative considerations.) |

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| B. | The determination of materiality is a matter of professional judgment, and involves both **quantitative** (the relative magnitude of the items in question) and**qualitative** (the surrounding circumstances) considerations. |
| C. | The auditor considers the concept of materiality throughout the audit process, including (a) in planning and performing the audit; (b) in evaluating the effect of uncorrected misstatements on the entity's financial statements; and (c) in forming the auditor's opinion.

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| 1. | In planning the audit -- The auditor should determine the materiality for the financial statements as a whole in connection with establishing the overall audit strategy. The auditor should determine "**performance materiality**" in connection with assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures at the relevant assertion level. |
| https://app1.efficientlearning.com/pv4/cpaexcel/common/images/note.gif**Note:**Previous AICPA auditing standards distinguished between "planning-stage materiality" and "evaluation-stage materiality." Current standards no longer make that distinction, but, instead, introduce the term *performance materiality*, which seems similar to what was meant by the term *planning-stage materiality* in the past. |
| "**Performance materiality**" -- The amount(s) set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole; if applicable, it is also the amount(s) set by the auditor at less than the materiality level(s) for particular classes of transactions, account balances, or disclosures."**Tolerable misstatement**" -- The application of performance materiality to a particular sampling procedure. |
| 2. | Revision during the audit -- The auditor should revise materiality for the financial statements as a whole and, if applicable, the materiality level(s) for specific classes of transactions or account balances when the auditor becomes aware of information affecting the auditor's initial judgments. The auditor should also determine whether "performance materiality" should be revised and whether the nature, timing, and extent of further audit procedures are appropriate. |

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| D. | **Documentation**  --  The auditor should document the following matters:

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| 1. | Materiality for the financial statements as a whole; |
| 2. | Materiality level(s) for particular classes of transactions, account balances, or disclosures, as applicable; |
| 3. | Performance materiality; and |
| 4. | Any revision of those considerations during the audit engagement. |

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| E. | Considerations that may affect the auditor's materiality judgment

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| 1. | **Quantitative guidelines**  --  In practice, auditors frequently apply a variety of "benchmarks" as a starting point in determining the appropriate materiality levels. A few examples of frequently used general guidelines follow (these are not specifically identified in the AICPA auditing standards, however):

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| a. | 5% - 10% of net income or earnings before taxes. |
| b. | 0.50% - 2% of the larger of net sales or total assets. |
| c. | 5% of owners' equity for private companies. |

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| 2. | **Qualitative matters**  --  The surrounding circumstances and perceived risks might affect the auditor's judgment of what is material to the users. There are too many such factors to list here, but two examples follow:

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| a. | Public versus private companies -- A lower materiality threshold may apply to public companies owing to more exposure to litigation and because the owners of private companies may be closer to the day-to-day operations and, therefore, have different information needs. |
| b. | Unstable versus stable industry -- A lower materiality threshold may apply to a company in an unstable industry, which is by nature more susceptible to business failure. |

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| 3. | **"Tolerable misstatement"**  --  (which, in practice, is sometimes referred to as "tolerable error") -- This term refers to the maximum error in a population that the auditor is willing to accept. This should be established in such a way that tolerable misstatement, combined for the entire audit plan, does not exceed materiality for the financial statements taken as a whole |

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| III. | **PCAOB Standards**The relevant PCAOB guidance is provided by Auditing Standard No. 11, "Consideration of Materiality in Planning and Performing an Audit." The auditor's responsibilities regarding materiality under the PCAOB standards are very similar to those under AICPA standards, although the PCAOB standard does not use the term "performance materiality." |
| **Audit Risk** |
| I. | **"Audit Risk"**

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| A. | **Definition of *Audit Risk*** --  "The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk." (Source -- AU200: "Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with [GAAS].") Note that the concept of audit risk is really a probability and that audit risk and materiality are interrelated by the definition of audit risk. |
| B. | The presence of audit risk is indicated in the auditor's report by reference to "reasonable assurance," meaning that audit risk cannot be reduced to a zero probability (which would imply "absolute assurance") owing to the inherent limitations of an audit. "Reasonable assurance" is defined as follows: "In the context of an audit of financial statements, a high, but not absolute, level of assurance." Note that *reasonable assurance* means a "high level of assurance" and a "low level of audit risk." |

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| II. | **Basic Auditor Responsibility**The auditor should properly plan and perform the audit to obtain reasonable assurance that material misstatements, whether caused by errors or fraud, are detected. |
| III. | **Considerations at the Financial Statement Level**The one over riding audit planning objective is to limit audit risk to an appropriately low level (as determined by the auditor's judgment), which involves the following:

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| A. | Determining the extent and nature of the auditor's risk assessment procedures. |
| B. | Identifying and assessing the risk of material misstatement. |
| C. | Determining the nature, timing, and extent of further audit procedures. |
| D. | Evaluating whether the financial statements taken as a whole are presented fairly in conformity with GAAP. |

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| IV. | **Risk of Material Misstatement**The "risk of material misstatement" (RMM) is defined as: "The risk that the financial statements are materially misstated prior to the audit." RMM exists at two levels: (1) the overall financial statement level; and (2) the assertion level for classes of transactions, account balances, and disclosures.

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| A. | RMM at the overall financial statement level -- This refers to risks that are "pervasive" to the financial statements and that potentially affect many assertions. |
| B. | RMM at the assertion level -- The auditor assesses RMM at the assertion level for the purpose of determining the nature, timing, and extent of further audit procedures to obtain sufficient appropriate audit evidence. RMM at the assertion level consists of two components: (1) inherent risk; and (2) control risk (see below). |
| C. | At the assertion level, "audit risk" consists of three component risk: (1) inherent risk (IR); (2) control risk (CR); and detection risk (DR). RMM consists of inherent risk and control risk. |
| AR = IR × CR × DR |
| **Definition** *Inherent risk (IR)* : The probability that a material misstatement would occur in the particular audit area in the absence of any internal control policies and procedures. |
| **Definition** *Control risk (CR)* : The probability that a material misstatement that occurred in the first place would not be detected and corrected by internal controls that are applicable. |
| **Definition** *Detection risk (DR)* : The probability that a material misstatement that was not prevented or detected and corrected by internal control was not detected by the auditor's substantive audit procedures (that is, an undetected material misstatement exists in a relevant assertion). |

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| V. | **Variations on the above "Audit Risk Model"**

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| A. | AR = RMM × DR, where:

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| 1. | "Risk of material misstatement" (RMM) -- the auditor's combined assessment of inherent risk and control risk (if IR and CR are not separately assessed).

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| Note that RMM = IR × CR |

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| B. | AR = RMM × TD × AP, where:

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| 1. | DR can be broken into two components involving the likelihood that the auditor's two basic categories of substantive procedures fail to detect a material misstatement that exists (1) "tests of details risk" (TD) and (2) "substantive analytical procedures risk (AP)."

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| Note that DR = TD × AP |

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| C. | AR = IR × CR × TD × AP |

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| VI. | **Quantification of the Risk Components**

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| A. | The component risks do not necessarily have to be quantified; for example, they could be assessed qualitatively as high, medium, or low. |
| B. | Each component is considered from left to right in order: audit risk is set, then inherent risk is assessed, then control risk is assessed, and finally the implications for the appropriate level of detection risk are considered. |
| C. | "Detection risk" is the only component risk that is specifically the auditor's responsibility -- "inherent risk" arises because of the particular audit area under investigation and "control risk" reflects management's responsibility to design and implement internal controls. Note that the auditor must "assess" inherent risk and control risk, but the auditor actually makes the decisions that, in effect, result in some level of detection risk, which should take into consideration the auditor's assessment of the risk of material misstatement.

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| 1. | If IR and CR are seen by the auditor as too high, the auditor must compensate by decreasing DR. |
| 2. | If IR and CR are perceived as low, the auditor may consider accepting a higher DR. |

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| D. | Increasing or decreasing DR is accomplished by adjusting the nature, timing, and/or extent of the auditor's substantive audit procedures. These might be viewed as the auditor's three strategic variables that, in effect, "set" DR based on the auditor's professional judgment about the following:

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| 1. | **Nature**  --  What specific audit procedures to perform (perhaps shifting the relative emphasis placed on the "soft evidence" analytical procedures versus the "hard evidence" tests of details)? |
| 2. | **Timing**  --  When will the procedures be performed, at an "interim" date (prior to year-end) or at "final" (after year-end when the books have been closed) and the auditor is actually auditing the numbers that the entity intends to report in its financial statements)? |
| 3. | **Extent**  --  Are large samples required for the auditor's test work or can somewhat smaller sample sizes be justified? How extensively should substantive procedures be performed? |

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| **Analytical Procedures** |
| **Definition** *Analytical procedures* : Evaluations of financial information through analysis of plausible relationships among both **financial and nonfinancial** data. (This includes any necessary follow-up investigation of fluctuations, significant differences, or inconsistent relationships.) |
| I. | **AICPA Guidance**The relevant AICPA guidance is provided by AU 520: "Analytical Procedures." This pronouncement states that the auditor's objectives are to: (1) obtain relevant and reliable audit evidence when using substantive analytical procedures; and (2) design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion about whether the financial statements are consistent with the auditor's understanding of the entity.

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| https://app1.efficientlearning.com/pv4/cpaexcel/common/images/note.gif**Note:**AU 520 replaces a previous AICPA auditing standard (then designated "AU 329"). The AICPA's nonauthoritative "Summary of Changes," addressing the Clarified Standards, pointed out, "The clarified SAS does not change or expand the requirements of extant AU section 329 in any significant respect." |
| A. | **Substantive analytical procedures**  --  When performing analytical procedures for substantive purposes, the auditor should: (1) determine the suitability of the particular analytical procedures for given assertions; (2) evaluate the reliability of the data from which the auditor developed the expectation; (3) develop an expectation of recorded amounts (or ratios) and evaluate whether the expectation is sufficiently precise; and (4) compare the recorded amounts (or ratios) with the auditor's expectations and determine whether any difference is acceptable without further investigation.

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| 1. | Substantive procedures may consist of substantive analytical procedures, tests of details, or some combination of both. The auditor makes judgments about the effectiveness and efficiency of such procedures to limit the assessed risk of material misstatement to an acceptably low level. |
| 2. | **Nature of assertion**  -- The effectiveness and efficiency of analytical procedures used for substantive purposes depends on 4 important considerations: (1) the nature of the assertion involved; (2) the plausibility and predictability of the relationship; (3) the availability and reliability of the data used as a basis for developing the expectation; and (4) the precision of the expectation. Analytical procedures may be particularly effective in testing for omissions (regarding the "completeness" assertion) of transactions that would be hard to detect with procedures that focus on recorded amounts. In other words, tests of details may not be effective when underlying source documents do not exist for transactions that went totally unrecorded, so analytical procedures may represent the best chance of detecting such omissions. |
| 3. | **Plausibility and predictability of relationship**  --  Developing a meaningful "expectation" to compare to the entity's recorded amount is critically important to the skillful use of analytical procedures

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| a. | Relationships in a stable environment are usually more predictable than those in a dynamic environment. |
| b. | Relationships involving income statement accounts tend to be more predictable than those involving balance sheet accounts (since the income statement deals with a period of time rather than a single moment in time). |
| c. | Relationships involving transactions subject to management discretion tend to be less predictable. |

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| 4. | **Availability and Reliability of Data**  --  Reliability increases when the data used are reliable, which is enhanced when the data are (a) obtained from independent external sources; (b) are subject to audit testing (either currently or in the past); or (c) are developed under conditions of effective internal control. |
| 5. | **Precision of Expectation**  --  The likelihood of detecting a misstatement decreases as the level of aggregation of the data increases. In other words, relationships of interest to the auditor may be obscured by the noise in the data at high levels of aggregation. For example, analyzing sales by month broken down by product line is more likely to be helpful to the auditor than simply comparing the current year's sales in total to the prior year's sales. |

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| B. | **Analytical procedures when forming overall conclusions**  --  The auditor should perform analytical procedures near the end of the audit that assist the auditor in forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity. These procedures may be similar to those used as "risk assessment procedures," and include reading the financial statements and considering any unusual or unexpected relationships that were not previously identified. As a result, the auditor may revise the assessment of the risks of material misstatement and modify the planned further audit procedures. |
| C. | **Investigating results of analytical procedures**  --  The auditor should investigate any identified significant differences by (1) inquiring of management (and corroborating management's responses with appropriate audit evidence, as necessary); and (2) performing other necessary audit procedures. |
| D. | **Documentation**  --  The auditor should include the following matters in the audit documentation:

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| 1. | The auditor's expectation and the factors considered in developing it; |
| 2. | The results of the comparison of the recorded amounts (or ratios) with the expectations; and |
| 3. | Any additional auditing procedures performed to investigate significant differences identified by that comparison. |

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| In summary, analytical procedures serve 3 audit purposes (two of which are required):

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| 1.  | For risk assessment (required!); |
| 2.  | For substantive purposes (widely used voluntarily, but not technically required); and |
| 3.  | As a final review (required!). |

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| **Detecting Fraud** |
| I. | **AICPA Guidance**The relevant AICPA guidance is provided by AU 240: "Consideration of Fraud in a Financial Statement Audit." This pronouncement states that the auditor's objectives are to: (1) identify and assess the risks of material misstatement due to fraud; (2) obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and (3) respond appropriately to fraud or suspected fraud identified during the audit.

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| **Definition** *Fraud* : An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception that results in a misstatement in the financial statements. |
| **Definition** *Fraud risk factors* : Events or conditions that indicate (a) an incentive or pressure to perpetrate fraud; (b) provide an opportunity to commit fraud; or (c) indicate attitudes or rationalizations to justify a fraudulent action. |
| A. | There are two different types of misstatements that are relevant to the auditor's consideration of fraud:

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| 1. | **Fraudulent financial reporting**  --  This type of fraud involves misstatements that are intended to deceive financial statement users (for example, the intent is to inflate the entity's stock price). Fraudulent financial reporting often involves management override of controls, recording fictitious journal entries, concealing facts, and altering underlying records to achieve the deception. This scenario is typically associated with a conspiracy involving multiple members of senior management to deceive the auditors, as well as financial statement users. |
| 2. | **Misappropriation of assets**  --  This type of fraud involves theft of assets causing the financial statements to be misstated owing to false entries intended to conceal the theft. Misappropriation of assets often involves embezzlement of receipts, stealing physical assets or intellectual property, and diverting the entity's assets for personal use. This scenario is typically associated with an individual bad actor operating individually to perpetrate and conceal the theft. |

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| II. | **The Auditor's Basic Responsibility Relates to Planning**

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| A. | In general, the auditor is required to design (plan) the audit to provide "reasonable assurance" of detecting misstatements that are material to the financial statements. In particular, the auditor should specifically assess the risk of material misstatement due to fraud (in addition to error), and design the audit procedures to be responsive to that risk assessment. That risk assessment should be performed at both the financial statement level and the assertion level. |
| https://app1.efficientlearning.com/pv4/cpaexcel/common/images/note.gif**Note:**AICPA Professional Standards focus on the auditor's responsibility for providing reasonable assurance of detecting material misstatements, whether due to error or fraud. The distinction depends upon whether the misstatement is intentional (which is the essence of fraud) or not. Intent may be difficult to determine, for example, when addressing accounting estimates, which are subjective by nature. |
| B. | Specifically, key audit team members must have a "brainstorming" discussion to consider how and where the financial statements might be susceptible to material misstatement owing to fraud and to emphasize the importance of maintaining professional skepticism. That discussion involving key members of the engagement team should consider such matters as the following:

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| 1. | Known internal and external fraud risk factors relevant to the entity; |
| 2. | The risk of management override of controls; |
| 3. | Indications of "earnings management" |
| 4. | The importance of maintaining professional skepticism throughout the engagement; and |
| 5. | How the auditor might respond to the risk of material fraud. |

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| https://app1.efficientlearning.com/pv4/cpaexcel/common/images/question.gif**Question:**Does failure to detect a material misstatement imply a substandard audit?**Answer:**No! An auditor may be unable to detect a material misstatement owing to forgery, collusion, or upper management involvement, etc. |

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| III. | **Inquiry and Analytical Procedures**To obtain information needed to identify the risks of material fraud the auditor emphasizes "inquiry" and "analytical procedures." (The auditor's important inquiries should be documented in the "Management Representations Letter" at the end of fieldwork!)

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| A. | **Inquiry**  --  The auditor should question management personnel about their knowledge of fraud, suspected fraud, or allegations of fraud; inquire about specific controls that management has implemented to mitigate fraud risks; and inquire about management's communications with those charged with governance about fraud-related issues. The auditor may also choose to question others (e.g., audit committee, internal auditors, operating personnel, in-house legal counsel, etc.) about fraud-related issues. |
| B. | **Analytical procedures**  --  The auditor should perform analytical procedures involving revenue accounts, in particular. In general, the auditor should consider whether any unexpected results associated with analytical procedures might have been intentional. |
| C. | There is a presumption that improper revenue recognition is a fraud risk. The auditor should ordinarily presume that there is a risk of material misstatement owing to fraud related to revenue recognition, and perform appropriate audit procedures (such as analytical procedures). |

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| IV. | **Fraud Risk Factors**The auditing standards identify three characteristics generally associated with fraud: (1) incentive/pressure; (2) opportunity; and (3) attitude/rationalization. These three categories of risk factors are sometimes referred to as the "fraud triangle."

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| A. | **Fraudulent financial reporting**  --  Example risk factors the auditor should consider:

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| 1. | **Incentive/pressure**  --  Reasons that management might be motivated to commit fraudulent financial reporting.

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| a. | Financial stability/profitability - When the entity is threatened by deteriorating economic conditions, for example: operating losses threaten bankruptcy; there are recurring negative cash flows from operations; there is vulnerability to rapid changes due to technology or other factors; there are increasing business failures in the industry; or the entity reports unusual profitability relative to others in the industry. |
| b. | Excessive pressure to meet the expectations of outsiders - Senior management may face significant pressure to meet external expectations, for example: there are overly optimistic press releases; the entity is only barely able to meet the stock exchange's listing requirements; the entity is having difficulty meeting debt covenants; or the entity must obtain additional outside financing to retool production to be competitive. |

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| 2. | **Opportunities**  --  Circumstances that might give management a way to commit fraudulent financial reporting.

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| a. | **Nature of the industry or the entity's operations**  --  For example: significant related-party transactions not in the ordinary course of business; ability to dominate suppliers or customers in a certain industry sector; unnecessarily complex transactions close to year-end raise "substance over form" issues; significant bank accounts or business operations in "tax-haven" jurisdictions with no clear business justification; major financial statement elements that involve significant estimates by management that are difficult to corroborate. |
| b. | **Ineffective monitoring of management**  --  For example, domination of management by a single person or small group without compensating controls or; ineffective oversight by those charged with governance. |
| c. | **Complex or unstable organizational structure**  --  For example, organization consists of unusual legal entities; high turnover of senior management, counsel, or board members. |
| d. | **Internal controls are deficient**  --  For example, inadequate monitoring of controls; high turnover rates in accounting, internal auditing, and information technology staff; ineffective accounting and information systems (There are significant deficiencies that rise to the level of material weaknesses. |

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| 3. | **Attitudes/rationalizations**  --  Attitudes, behaviors or justifications of management that might be associated with fraudulent financial reporting:

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| a. | Lack of commitment to establishing and enforcing ethical standards. |
| b. | Previous violations of securities laws (or other regulations). |
| c. | Excessive focus by management on the entity's stock price. |
| d. | Management's failure to correct reportable conditions. |
| e. | Pattern of justifying inappropriate accounting as immaterial. |
| f. | Management has a strained relationship with the predecessor or current auditor. |

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| B. | **Misappropriation of assets**  --  Example risk factors the auditor should consider:

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| 1. | **Incentive/pressure**  --  An employee or member of management might be motivated to commit the misappropriation for a variety of reasons, such as the following: employees who have access to cash (or other assets susceptible to theft), may have personal financial problems, or they may have adverse relationships with the entity under audit, (perhaps in response to anticipated future layoffs or recent decreases to their benefits or compensation levels). |
| 2. | **Opportunities**  --  Circumstances that might give someone a way to commit the misappropriation include the following:

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| a. | When assets are inherently vulnerable to theft -- For example, there are large amounts of liquid assets on hand, or inventory items are small, but valuable. |
| b. | Inadequate internal control over assets -- For example, there is inadequate segregation separation of duties, inadequate documentation or reconciliation for assets, or inadequate management understanding related to information technology. |

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| 3. | **Attitudes/rationalizations**  --  The individual perpetrating the misappropriation might possess attitudes or justifications that might be associated with that rationalize the improper behaviors and avoid any feelings of remorse for this misconduct. Generally, the auditor cannot normally observe these attitudes, but should consider the implications of such matters when they are discovered. The following might be of interest to the auditor:

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| a. | The employee's behavior indicates dissatisfaction with the entity under audit. |
| b. | There are changes in the employee's behavior or lifestyle that are suspicious. |
| c. | The employee exhibits a disregard for internal control related to assets by overriding existing controls or failing to correct known deficiencies. |

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| C. | **Consideration of the effects of the risk factors**  --

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| 1. | The auditor should use judgment in considering the individual or collective effects of the risk factors and recognize that the effects of these risk factors vary widely. |
| 2. | Specific controls may mitigate the associated risks, and specific control deficiencies may add to the risks. |

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| D. | Conditions may be discovered during fieldwork that cause the assessment of these risks in the planning stage to be modified. Factors that might cause the auditor's concerns to increase include the following examples:

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| 1. | There are discrepancies in the accounting records including inaccuracies or unsupported balances. |
| 2. | There is conflicting or missing evidence including missing documents or the absence of original documents that should be available (perhaps only photocopies are available). |
| 3. | There is a problematic relationship between the auditor and the entity including restricted access of the auditor to records or personnel and undue time pressures imposed by management. |

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| E. | **Responses to risk assessment**  --  In response to this risk assessment related to fraud, the auditor may conclude that the planned procedures should be modified or that control risk should be reconsidered. The auditor might make some "overall responses" (at the financial statement level, such as assigning more experienced staff to the engagement) and make other responses "at the assertion level" (by designing audit procedures for which the nature, timing, and extent of those procedures are responsive to the assessed risks of fraud).

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| 1. | **Overall responses**  --  The auditor may decide to assign more experienced personnel or information technology specialists to the engagement. The auditor should incorporate a degree of "unpredictability" in audit testing, whether at the financial statement level or the assertion level (for example, visiting some locations for inventory counts on an unannounced basis) or selecting some items for testing that are below materiality levels. |
| 2. | **Responses at the assertion level**  --  The auditor may decide to increase the emphasis on audit procedures that provide a stronger basis for conclusions or to confirm the terms of sales transactions, in addition to receivable balances; the auditor may move important audit testing to year-end, instead of performing those tests at an interim date; and/or the auditor may increase sample sizes for audit testing. |
| 3. | **Addressing management override of controls**  --  The auditor should obtain an understanding of the entity's controls over journal entries and inquire about unusual activity. Selected journal entries at the end of the period should be examined. The auditor should also review accounting estimates for bias, and might perform a "retrospective review" of significant accounting estimates in the prior year. The auditor should specifically evaluate any significant unusual transactions outside the entity's normal course of business. |

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| F. | **Management override**  --  Auditors should plan procedures specifically to address management override of internal control. Management override means that upper management may not be affected by controls that are imposed on subordinates throughout the organization. (Therefore, management may be able to sidestep those controls without leaving an audit trail for discovery.)

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| 1. | **Examine adjusting journal entries**  --  The auditor should be especially attentive to nonstandard journal entries (involving unusual accounts or amounts and those involving complex issues or significant uncertainty). Likewise, the auditor should also be especially attentive to journal entries near the end of the reporting period (both for the fiscal year and any applicable interim reporting periods, such as quarterly reports). |
| 2. | **Evaluate accounting estimates for bias**  --  The auditor should consider performing a "retrospective review," which means evaluating prior years' estimates for reasonableness in light of facts occurring after those estimates were made. In other words, did later events support or refute the appropriateness of management's estimates in prior periods? That may affect the auditor's perception of the reliability of management's estimates in the current period. |
| 3. | **Evaluate the business rationale for any unusual transactions**  --  The auditor should look for appropriate authorization of any unusual transactions by those charged with governance. |

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| **Fraud: Evaluation and Communication** |
| I. | **Evaluation of Audit Test Results**Near the end of the audit, the auditor should evaluate whether the results of the auditing procedures affect the auditor's initial assessment of material fraud risk. (The analytical procedures related to revenue should be performed through the end of the period.)

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| A. | When evaluating identified misstatements of the financial statements, the auditor should consider whether such misstatements might be indicative of fraud. For example, the auditor might consider the organizational level involved. If a misstatement may be the result of fraud involving management, the auditor should reevaluate the assessment of material fraud risk and the auditor's response to the assessed risks. |
| B. | If the misstatement is (or may be) the result of fraud and the effect could be material to the financial statements (or if the auditor has been unable to evaluate the materiality involved):

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| 1. | Attempt to obtain additional evidence to determine the facts as to the cause and whether the financial statements are misstated. Discuss the issues and any further investigation required with an appropriate level of management (at least one level above those believed to be involved) and with those charged with governance (especially if senior management appears to be involved). |
| 2. | If the auditor encounters circumstances related to fraud that call into question whether it is appropriate to continue the audit, the auditor should determine the applicable professional and legal responsibilities, and consider whether it is appropriate to withdraw from the engagement. If the auditor withdraws, then the matter should be discussed with management and those charged with governance. (Circumstances that may call into question the auditor's ability to continue the audit include the following: (a) the entity does not take appropriate action regarding fraud; (b) audit evidence suggests that there is a significant risk of pervasive fraud; and (c) the auditor has significant concerns about the competence or integrity of management or those charged with governance.) |

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| II. | **Required Documentation**The auditor should document the following matters related to the consideration of fraud in the financial statement audit:

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| A. | The discussion among engagement personnel about fraud in planning the audit, including how and when the discussion occurred, the team members who participated, and the subject matter discussed; |
| B. | The procedures performed to obtain information necessary to assess the risks of material fraud. |
| C. | Specific risks of material fraud that were identified at the financial statement level and at the assertion level, including a description of how the auditor responded to those identified risks (including the linkage of audit procedures to the risk assessment); |
| D. | Reasons supporting the auditor's conclusion if revenue recognition was not identified as a fraud risk contrary to the presumption that revenue recognition is a fraud risk; |
| E. | The results of procedures performed to further address the risk of management override of controls; |
| F. | Other conditions and analytical relationships that caused the auditor to perform additional auditing procedures; and |
| G. | The nature of any communication about fraud made to management, those charged with governance, regulators, and others. |

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| III. | **Required Communications when Fraud is Detected or Suspected**The auditor's communication of fraud issues with management (or those charged with governance) may be written or oral, but should be timely. As indicated above, such communication should be documented in the audit documentation.

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| A. | If the fraud is not material to the financial statements and senior management is not involved in the fraud, the appropriate level of management (which is usually considered to be at least one level above where the fraud is believed to have occurred) should be notified. Determining the appropriate level of management for such communication is a matter of judgment, and includes consideration of the likelihood of collusion within management. |
| B. | If the fraud is material to the financial statements or if senior management is involved in the fraud, those charged with governance should be notified. |
| C. | **Other matters related to fraud**  --  The auditor may choose to discuss a variety of other matters with those charged with governance, including the following:

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| 1. | Concerns about the adequacy of management's assessment of the entity's controls to prevent and detect fraud; |
| 2. | Failure by management to respond appropriately to identified fraud or to address identified significant deficiencies in internal control; |
| 3. | Concerns about the entity's control environment, including the competence or integrity of management; |
| 4. | Concerns about management's efforts to "manage earnings"; and |
| 5. | Concerns about the authorization of transactions that do not appear to be within the normal course of the entity's business. |

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| D. | The auditor should consider whether any identified fraud risk factors may constitute a "significant deficiency" (or material weakness) regarding internal control that should be reported to senior management and those charged with governance. |
| E. | **"Whistle-blowing"**  --  Informing others (outside) the entity such as regulatory and enforcement authorities, is ordinarily prohibited by the auditor's confidentiality requirements, although the duty of confidentiality may be overridden by law or regulation (or the requirements of audits for governmental entities). Accordingly, it would be appropriate for the auditor to seek legal guidance when facing such circumstances. The auditing (and ethical) standards historically have identified 4 basic exceptions to the auditor's confidentiality requirements:

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| 1. | The auditor must respond truthfully to a valid legal subpoena. |
| 2. | The auditor must comply with applicable legal and regulatory requirements (including complying with the SEC's 8-K requirements about important matters, such as the entity's decision to change auditors). |
| 3. | A predecessor auditor must respond appropriately to the successor auditor's inquiries when the former client has given permission for the predecessor auditor to respond to the auditor's questions. |
| 4. | The auditor must report fraud to the applicable funding agency under the requirements of government auditing standards. |

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| **ext :: Internal Control Concepts 1** |   |
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| **Internal Control Concepts 1** |
| I. | **Review Phase**The auditor should obtain an initial understanding of internal controls and document that understanding.

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| A. | The auditor obtains an **understanding of internal control**and the flow of documents related to the entity's transactions primarily through:

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| 1. | Inquiry of appropriate personnel; |
| 2. | Observation of client activities; |
| 3. | Review of documentation -- The auditor reviews relevant documentation, including the client's accounting manuals, prior-year's audit documentation (working papers), etc. |

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| B. | The auditor's internal control analysis tends to focus on the entity's major transaction cycles. |
| C. | **"Transaction cycle"**  --  Defined to be a group of essentially homogeneous transactions, that is, transactions of the same type.. |
| D. | **Implication**  --  A specific transaction cycle is the highest level of aggregation about which meaningful generalizations of control risk can be made, since control risk is constant within that transaction cycle. Each transaction within a specific transaction cycle is captured, processed, and recorded subject to the same set of internal control policies and procedures. |
| E. | **Examples of typical transaction cycles**  --  Typical examples, include the following:

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| 1. | Revenue/receipts; |
| 2. | Expenditures/disbursements; |
| 3. | Payroll; |
| 4. | Financing/investing activities; and |
| 5. | Inventory, especially if inventory is manufactured, rather than purchased. |

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| F. | **Document the auditor's understanding**  --  The auditor should document that understanding of internal control. The extensiveness of the review and documentation varies with the circumstances (e.g., the emphasis on understanding internal controls increases if reliance on internal control is planned):

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| 1. | **Flow charts of transaction cycles**  --  A graphical depiction of the client's accounting systems for major categories of transactions with emphasis on the origination, processing, and distribution of important underlying accounting documents.

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| a. | **Advantages**  --  A fairly systematic approach that is unlikely to overlook important considerations; tailored to client-specific circumstances; fairly easy for others to review and understand; and fairly easy to update from year to year. |
| b. | **Disadvantages**  --  Can be rather tedious and time consuming to prepare initially although available commercial software today may eliminate much of that difficulty; the auditor might fail to recognize relevant internal control deficiencies by getting too absorbed in the details of documenting the client's system. |

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|   | http://www.cpaexcel.com/pv4/cpaexcel/courses/21/images/aud_019_a.png |
| 2. | **Internal control questionnaires (ICQs)**  --  Questionnaires consisting of a listing of questions about client's control procedures and activities; a "no" answer is usually designed to indicate a control weakness.

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| a. | **Advantages**  --  Generic questionnaires can be prepared in advance for clients in various industry categories with every conceivable question, so that no important question related to controls is likely to be omitted; deficiencies are easily identified by a client's "no" response to any question. |
| b. | **Disadvantages**  --  Generic questionnaires are not tailored to client-specific circumstances and irrelevant questions are annoying to client personnel; the client personnel responding to the checklist of questions may conceal deficiencies by inaccurate answers without the auditor's knowledge. |

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| 3. | **Narrative write-ups** --  A written memo describing the important control-related activities in the transaction cycles under consideration.

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| a. | **Advantages**  --  Memos can be tailored to a client's unique circumstances, can be as detailed or general as desired, and are relatively easy to prepare (and easy for reviewers to read it). |
| b. | **Disadvantages**  --  It is relatively easy to overlook relevant internal control issues (strengths or weaknesses) because the analysis is fairly unstructured. |

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| G. | **Perform a "walkthrough"**  --  The auditor may select a few transactions to trace them through the client's accounting system. The purpose is merely to get some feedback as to whether the auditor has accurately understood (and documented) the way the client entity is processing transactions. The walkthrough is not considered "evidence" or a form of documentation and should not be confused with "tests of control." |

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