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CPE COURSE

Perry M. Henderson, CPA, MPA

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Perry M. Henderson, CPA, MPA
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TOP AUDITING ISSUES FOR 2013 CPE COURSE

Introduction

The year 2013 brings many “new and improved” professional standards. These include:
- The AICPA’s new *Codification of Statements on Auditing Standards (Clarified)*
- The GAO’s new *Government Auditing Standards*
- COSO’s new *Internal Control—Integrated Framework*

The volume of information in these pronouncements is staggering and will have to be implemented within a fairly compressed time frame. This course provides up-to-date information on each of these pronouncements. It also summarizes several of the specific clarified and redrafted auditing standards, offers practical guidance on working with the new *Codification of Statements on Auditing Standards (Clarified)*, and discusses ongoing implementation issues that firms are facing in compilation, review, and audit practice from a problems-and-solutions perspective.

This course is structured in four Modules. The first Module covers the independence, financial audits, and performance audits sections of the 2011 release of *Government Auditing Standards*. It is effective for periods ended on or after December 15, 2012, for financial statement audits or attestation engagements, and for performance audits beginning on or after December 15, 2011. Chapters 1 and 2 are intermediate level courses requiring basic understanding of *Government Auditing Standards*. Chapter 3 is an overview level course that addresses the requirements for performance audits under *Government Auditing Standards*.

The content of Module 1 is:
- Chapter 1: The Conceptual Framework Approach to Independence
- Chapter 2: Financial Audits
- Chapter 3: Performance Audits

Module 2 covers implementation issues in compilation, review, and audit engagements. It also introduces the principles underlying an audit under the AICPA’s clarified and redrafted standards, and summarizes the hierarchy of professional standards. This module will be of general interest to all firms with audit and accounting practices. Chapter 4 is a basic level course that addresses the top ten implementation issues that firms are facing with SSARS 19. Chapter 5 is a basic level course that introduces the broad philosophical principles underlying an audit, which are contained in the preface to the clarified and redrafted standards. Chapter 6 is a basic level course that summarizes the new hierarchy of professional standards for compilation,
review, audit, and attest services. Chapter 7 is an overview level course that discusses numerous implementation issues that firms continue to face with recently effective auditing standards.

The content of Module 2 is:
- Chapter 4: Top Ten Implementation Issues—SSARS 19
- Chapter 5: Principles Underlying an Audit
- Chapter 6: Hierarchy of Professional Standards
- Chapter 7: Current Implementation Issues for Auditing Standards

Module 3 summarizes three specific clarified and redrafted auditing standards on a basic level. This module covers specialized topics that will be of interest to firms dealing with foreign GAAP financial statements, supplementary information, or reviews of interim financial information.

The content of Module 3 is:
- Chapter 8: SAS 124: Auditing Foreign GAAP Financial Statements
- Chapter 9: Reporting on Supplementary Information
- Chapter 10: Interim Financial Information

Module 4 digests two significant new bodies of professional literature and one specific new standard. Chapter 11 summarizes the clarified and redrafted standard on Reporting on Compliance with Contractual Agreements or Regulatory Requirements, on a basic level. Chapter 12 summarizes, on an overview level, some of the more significant changes between previous auditing standards and the new Codification of Statements on Auditing Standards (Clarified), and provides practical guidance for working with and smoothly implementing this new body of standards. Chapter 13 offers a concise summary, on an overview level, of the structure and content of the updated COSO Internal Control—Integrated Framework.

The content of Module 4 is:
- Chapter 11: Reporting on Compliance with Contractual Agreements or Regulatory Requirements
- Chapter 12: Working with the New Codification of Statements on Auditing Standards (Clarified)
- The COSO Internal Control—Integrated Framework 2012

**Study Questions.** Throughout the course you will find Study Questions to help you test your knowledge, and comments that are vital to understanding a particular strategy or idea. Answers to the Study Questions with feedback on both correct and incorrect responses are provided in a special section beginning on page 157.

**Index.** To assist you in your later reference and research, a detailed topical index has been included for this course beginning on page 177.
**Quizzer.** This course is divided into four Modules. Take your time and review all course Modules. When you feel confident that you thoroughly understand the material, turn to the CPE Quizzer. Complete one, or all, Module Quizzers for continuing professional education credit.

Go to [CCHGroup.com/PrintCPE](http://CCHGroup.com/PrintCPE) to complete your CPE Quizzers online for immediate results and no Express Grading Fee. Further information is provided in the CPE Quizzer instructions on page 187.

**September 2012**

Perry M. Henderson, CPA, MPA

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**COURSE OBJECTIVES**

This course was prepared to provide the participant with:

- Intermediate and overview level coverage of the new GAO Yellow Book pertaining to independence, financial audits, and performance audits
- Basic and overview level discussion of practical implementation issues in compilation, review, and audit engagements, and basic level summaries of the principles underlying an audit under the AICPA’s clarified and redrafted standards, and the new hierarchy of professional standards
- Summaries of three specific clarified and redrafted auditing standards on a basic level, which will be of interest to firms dealing with foreign GAAP financial statements, supplementary information, or reviews of interim financial information
- Digested coverage, on an overview level, of:
  - Significant changes between previous auditing standards and the new *Codification of Statements on Auditing Standards (Clarified)*, along with practical guidance for working with and smoothly implementing this new body of standards
  - The structure and content of the updated COSO *Internal Control—Integrated Framework*
  - The clarified and redrafted standard on *Reporting on Compliance with Contractual Agreements or Regulatory Requirements*, on a basic level
Upon completion of this course, the reader should be able to:

- Define the categories of independence listed in Government Auditing Standards and explain the application of the conceptual framework approach to independence
- List the safeguards contained in the conceptual framework
- Explain how to evaluate the effects of nonaudit services on auditor independence
- List prohibited nonaudit services
- Identify and explain the additional requirements of Government Auditing Standards for financial audits that go beyond the requirements of generally accepted auditing standards
- Identify changes to previous standards related to performance audits
- Determine required procedures to apply during the field work in performance audits
- Identify and explain documentation and reporting requirements for performance audits
- Recognize the two new key elements for compilation and review reports under SSARS 19
- Explain the requirements for obtaining an understanding with management in compilation and review engagements
- List the minimum required management representations in a review engagement
- Describe the attributes of properly documented analytical procedures
- Explain the purpose of an audit and the premises on which an audit is conducted
- Distinguish between the responsibilities of the entity’s management and those of the auditor in conducting an audit
- Explain the concept of reasonable assurance
- Define the levels of accounting guidance as determined by the Financial Accounting Standards Board (FASB)
- Explain the practitioner’s responsibilities for applying guidance contained in the various levels of auditing, attestation, and compilation and review literature
- Distinguish the authoritative levels of auditing, attestation, and compilation and review publications
- Recognize current auditing standards implementation issues facing the profession
- Describe the effects on auditing practice of certain recent changes in professional standards
- Explain the causes of certain auditing standards implementation problems, and their possible solutions
- Explain the applicability of U.S. generally accepted auditing standards and other auditing standards to engagements to audit foreign GAAP financial statements
- Explain the auditor’s responsibilities in reporting on foreign GAAP financial statements
Identify supplementary information and required supplementary information and distinguish them from other information in documents containing audited financial statements

List the professional requirements related to supplementary information, required supplementary information, and other information in documents containing audited financial statements

Explain the reporting requirements for supplementary information and required supplementary information in audit, review, and compilation engagements

Recognize situations in which AU-C section 930, *Interim Financial Information*, is applicable

Define characteristics of a review of interim financial information that distinguish it from engagements under other standards

List analytical procedures and inquiries that are normally performed in connection with a review of interim financial statements

Describe the requirements for reporting under various circumstances in a review of interim financial information

Cite the effective date of the new *Codification of Statements on Auditing Standards (Clarified)*

Describe the organization of the new *Codification*

Identify significant changes to auditing practice resulting from the new *Codification*

Describe elements of a successful implementation program for the new *Codification*

Identify the circumstances in which the standard for *Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements* applies and distinguish them from circumstances in which it does not apply

List the attributes of a compliance report

Explain the implications for the compliance report of the auditor’s report on the financial statements

Recognize the alternative forms of compliance reports

Define *internal control* according to the Committee of Sponsoring Organizations of the Treadway Commission’s *Internal Control—Integrated Framework*

Explain the significance of the components, principles, and attributes of the *Framework*

Recognize specific principles and attributes associated with the *Framework’s components*

One complimentary copy of this course is provided with certain copies of CCH publications. Additional copies of this course may be downloaded from CCHGroup.com/CPE or ordered by calling 1-800-248-3248 (ask for product 0-4286-500).
ABOUT THE AUTHOR

Perry M. Henderson has over thirty years of experience in public accounting. For over twenty years, he has been a sole practitioner providing audit and accounting services to nonprofit organizations and privately held businesses. He has performed peer reviews of about five hundred accounting firms and has served on the Peer Review Committee and Professional Conduct Committee of the California Society of CPAs, and the Executive Committee of the AICPA Governmental Audit Quality Center. He is the author of the *CPA’s Guide to Quality Control and Peer Reviews*, and of *Top Auditing Issues* since 2006. He also has contributed material to several other CCH publications, and to various publications of the AICPA and the California Society of CPAs.

Mr. Henderson holds a bachelor’s degree from Claremont McKenna College and a master’s degree in public administration from the University of Oklahoma. He has been as an adjunct faculty member at the University of Redlands. His greatest ambition in life is to become a character in a Jimmy Buffett song.
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INTRODUCTION

The 2011 release of Government Auditing Standards (the Yellow Book) states the unconditional requirement that in all matters related to audit work, the audit organization and the individual auditor, whether government or public, must be independent.

This release of the Yellow Book contains a new conceptual framework approach to independence that is one of the most important changes to existing standards. It moves toward a more principles-based platform, and away from a strictly rule-driven regime. This shift in the Government Accountability Office’s (GAO) thinking is consistent with the trend of both generally accepted auditing standards in the United States (GAAS) and International Auditing Standards.

The new conceptual framework is adaptable, and allows auditors to assess unique circumstances. It combines a set of rules, which prohibit certain services and relationships, with a broader framework to assess the effect on independence of performing services or maintaining relationships that are not listed among those that are strictly forbidden. The framework is thus a hybrid concept that tries to balance rules-based standards with more overarching principles. Auditors are required to analyze all circumstances and relationships that may result in threats to independence, and all permitted nonaudit services, using the threats-and-safeguards features of this framework.

The revised independence provisions now apply to an entire period under audit. For this reason, it is important that practitioners become familiar with them before their effective date. That date is for periods ended on...
or after December 15, 2012, for financial statement audits or attestation engagements, and for performance audits beginning on or after December 15, 2011. Early implementation is not permitted.

DEFINITIONS

Independence
The new Yellow Book defines two categories of independence:

- **Independence of mind**, which is a state of mind that permits the performance of an audit without being affected by influences that compromise professional judgment. Having independence of mind allows individual auditors to act with integrity and exercise objectivity and professional skepticism.

- **Independence in appearance**, which is the absence of circumstances that would cause a reasonable and informed third party, having knowledge of relevant information, to reasonably conclude that the integrity, objectivity, or professional skepticism of an audit organization or member of an audit team had been compromised.

STUDY QUESTION

1. Which of the following statements best characterizes *independence in appearance*, according to *Government Auditing Standards*?
   
   a. The absence of circumstances that would cause members of the general public to believe that the integrity of a member of an audit team had been compromised
   
   b. The absence of circumstances that would cause an informed third party with knowledge of relevant information to believe that the integrity, objectivity, or professional skepticism of an individual auditor or an audit organization had been compromised
   
   c. The ability of the audit organization to maintain a collective state of mind that permits it to perform the audit without being affected by influences that compromise professional judgment
   
   d. Constitutional or statutory provisions under which the governmental audit organization is in a different branch of government than the audited entity

Period of Professional Engagement

The period of the professional engagement is defined as follows.

Beginning on the earlier of:

- When the auditors sign an initial engagement letter or other agreement to perform an audit, or
- When the auditors begin to perform an audit.
Ending with the later of:
- The issuance of a report, or
- The termination of the professional relationship through formal or informal notification by either party.

The period of the professional engagement lasts for the duration of the professional relationship. For recurring audits, this could cover multiple accounting periods. The period of the professional engagement does not necessarily end with the issuance of a report and recommence at the inception of the next year’s audit.

**OBSERVATION**
The period of the professional engagement is important because, except under narrowly limited circumstances, auditors should be independent of the audited entity during the entire period of the professional engagement.

**Threats to Independence**
*Threats to independence* are circumstances that could impair independence. A threat, in itself, does not necessarily impair independence.

**CONCEPTUAL FRAMEWORK APPROACH TO INDEPENDENCE**
The conceptual framework is made up of two concepts: threats to independence, and safeguards against those threats. Its purpose to enable auditors to:
- Identify threats to independence
- Evaluate significant threats identified, both individually and in the aggregate
- Apply safeguards as necessary to either eliminate or reduce threats to an acceptable level

The Yellow Book says that auditors should apply the conceptual framework at three levels:
- The audit organization (or audit firm)
- The audit
- The individual auditor
Threats to Independence

The Yellow Book identifies seven specific threats to independence that auditors should evaluate when threats are being considered.

- **Self-interest** is the threat that financial or other interest will have inappropriate influence on an auditor’s behavior or judgment.
- **Self-review** is the threat that nonaudit services provided by the auditor or audit organization will not be appropriately evaluated as part of the audit.
- **Bias** is the threat that an auditor will take a position that is not objective due to political, ideological, social, or other convictions.
- **Familiarity** is the threat that an auditor will take a position that is not objective due to aspects of a relationship with management or with the audited entity’s personnel, such as a close or long relationship, or that of a close or immediate family member.
- **Undue influence** is the threat that an auditor’s ability to make independent and objective judgments will be affected by external influences or pressures.
- **Management participation** is the threat that arises from an auditor’s taking on the role of management or otherwise performing management functions on behalf of the audited entity.
- **Structural threat** is the threat that an audit organization’s placement within the organizational structure of a government entity being audited will affect the audit organization’s ability to perform and report on the audit objectively.

**OBSERVATION**

Except for the structural threat, which is unique to *Government Auditing Standards*, the GAO and AICPA frameworks cover the same threats to independence, with only minor differences in terminology. The GAO’s bias threat, for example, covers both the advocacy threat and the adverse interest threat in the AICPA standards.

**STUDY QUESTION**

2. *Government Auditing Standards* lists all of the following as threats to independence except:

   a. Structural threat
   b. Familiarity threat
   c. Bias
   d. Political influence
Safeguards

Safeguards are controls designed to eliminate threats to independence, or to reduce them to acceptable levels. They are sensitive to facts and circumstances in each individual case. Under the conceptual framework, auditors apply safeguards to address specific threats. Independence is impaired if no safeguards can be applied to eliminate an unacceptable threat or to reduce it to an acceptable level.

The Yellow Book provides examples of safeguards that may be effective. At the audit organization level, those include:

- Consulting an independent third party
- Involving another audit organization to perform or reperform part of the audit
- Review of audit work by a professional staff member who was not a part of the audit team
- Removing individuals from the audit team when their financial or other interests or relationships create threats to independence

Safeguards may also be applied by the audited entity. Auditors may be able to place limited reliance on those safeguards, but cannot rely on them solely to eliminate or reduce threats.

Examples of those safeguards include:

- An entity-imposed requirement that auditor appointment be ratified or approved by persons outside of management
- The entity’s internal procedures that ensure objective choices in procuring nonaudit services
- A governance structure that provides appropriate oversight and communication concerning the audit organization’s services

**OBSERVATION**

The GAO standards are more rigorous than the AICPA standards in that they do not allow the auditor to rely solely on safeguards implemented at the audited entity.

**STUDY QUESTION**

3. *Government Auditing Standards* lists all of the following as safeguards that can be applied at the audit organization level to eliminate or reduce threats to independence, **except:**

   a. A governance structure at the audited entity that provides appropriate oversight concerning the audit organization’s services
   b. Involvement of another audit organization to perform part of the audit
   c. Review of audit work by a professional staff member who was not a part of the audit team
   d. Consultation with an independent third party
Applying the Conceptual Framework

Auditors should apply the conceptual framework to evaluate threats to independence. They should evaluate threats both individually and in the aggregate because threats can have a cumulative effect on independence.

Many events can create threats to independence. Auditors use professional judgment to determine whether the facts and circumstances created by an event warrant applying the conceptual framework. When relevant new information about a threat to independence becomes known, the auditor should evaluate the threat’s significance in accordance with the framework. Examples of events that can give rise to threats are:

- The start of a new audit
- The assignment of new staff to an ongoing audit
- Acceptance of a nonaudit service for an audited entity

Auditors should determine whether threats are at an acceptable level, or can be reduced to an acceptable level or eliminated. A threat is unacceptable if it could either:

- Affect the auditor’s ability to perform the audit without influences that compromise professional judgment, or
- Expose the auditor or audit organization to circumstances in which an informed and reasonable third party would conclude that the integrity, objectivity, or professional skepticism of the audit organization or a member of the audit team had been compromised.

When an auditor identifies an unacceptable threat to independence, the auditor should determine whether safeguards are available to eliminate it, or reduce it to an acceptable level. This determination involves professional judgment. It takes into account:

- Independence of mind
- Independence in appearance
- Qualitative factors
- Quantitative factors

Auditors are required to document threats that they consider to be at an unacceptable level, and the safeguards applied to eliminate or reduce them.

**Observation**

The Yellow Book does not require auditors to document threats that do not rise to an unacceptable level. Nor does it require them to “apply the framework” to those threats.
Some threats are so significant that they cannot be eliminated or reduced to an acceptable level by applying safeguards. This results in impaired independence. Auditors should decline to perform a prospective audit under these circumstances, or should terminate an audit already in progress.

**Government Auditors**

The independence standard applies to auditors in government entities. This is true whether they report to third parties externally (external auditors) or to senior management within the audited entity (internal auditors), or to both. The ability of an audit organization to objectively perform and report on its work can be affected by its placement within the government and the structure of the audited entity.

**External auditor independence.** Constitutional or statutory safeguards are often in place to mitigate structural threats to independence for audit organizations that are structurally located within government entities. For external auditors, these may include structures under which the government audit organization is:

- At a different level of government than the audited entity, such as state auditors auditing a local government program
- In a different branch of government than the audited entity, such as executive branch auditors auditing a legislative program

Structural threats can also be mitigated if the head of the audit organization meets any of the following criteria in accordance with constitutional or statutory requirements:

- Directly elected by voters of the audited jurisdiction
- Elected or appointed by a legislative body, subject to removal by a legislative body, and accountable to and reports audit results to a legislative body
- Appointed by other than a legislative body, as long as the appointment is confirmed by and removal is subject to approval or oversight by a legislative body, and accountable to and reports audit results to a legislative body
- Appointed by, accountable to, reports to, and can only be removed by a statutorily created governing body outside the audited entity, with a majority of its members independently elected or appointed

The Yellow Book also recognizes that there may be other organizational structures under which external audit organizations in government entities could be considered to be independent. When properly implemented, these structures prevent the audited entity from interfering with the audit. An external audit organization, or an audit organization that reports both
Internally and externally, should have all of the following safeguards and should document how each was satisfied.

- Statutory protections preventing the audited entity from abolishing the audit organization
- Statutory protections requiring that removal of the head of the audit organization be reported to the legislative body
- Statutory protections preventing the audited entity from interfering with any audit, including the reporting on the audit
- Statutory protections requiring the audit organization to regularly report to the legislature or other independent governing body
- Statutory protections giving the audit organization sole hiring, retention, advancement, and dismissal authority over its staff
- Statutory access to records and documents and government officials or other persons related to the audited entity as necessary to conduct the audit

**Internal auditor independence.** Internal auditors are employed to work for, and may be subject to administrative direction by, entity management. They are considered independent for purposes of reporting internally if the head of the audit organization meets all of the following criteria:

- Is accountable to either the head, deputy head, or those charged with governance of the government entity
- Reports audit results to both the head or deputy head, and those charged with governance
- Is outside of the staff or line management function of the unit under audit
- Has access to those charged with governance
- Is sufficiently removed from political pressures to conduct and report on audits objectively without fear of reprisal

An internal audit organization can be independent when it performs an audit of an external party, such as a contractor, when no impairments to independence exist.

**PROVIDING NONAUDIT SERVICES**

Auditors have customarily provided a range of nonaudit services in connection with audit engagements. Some of these services may create threats to independence.

**Requirements for Performing Nonaudit Services**

Before providing nonaudit services, the auditor should determine whether they create threats to independence. A key component of this consideration is whether management has the ability to effectively oversee the nonaudit services. The auditor should:
Determine that the audited entity has designated an individual with suitable skill, knowledge, or experience who understands the nonaudit services sufficiently to oversee them

Document consideration of management’s ability to effectively oversee the nonaudit services

Obtain assurance that management performs the following functions with respect to the nonaudit services:
- Assumes all management responsibilities for the nonaudit services
- Evaluates the results and adequacy of the services
- Accepts responsibility for the results of the services

**Observation**
The Yellow Book explicitly states that the individual designated to oversee the nonaudit services need not have the expertise to perform, or to reperform, those services. This has been likened to a homeowner hiring an electrician to install a light switch. The homeowner can effectively oversee this service by turning the switch and seeing that the lights come on, without having an electrician’s license or knowing how to install the switch himself.

**Management activities.** Some activities are always prohibited. If an auditor assumes management responsibilities, such as leading or directing an entity or making decisions about acquiring, deploying, or controlling its resources, the management participation threat becomes so strong that no safeguard can reduce it to an acceptable level.

Whether an activity is a management responsibility depends on facts and circumstances, and is subject to the auditor’s professional judgment in identifying the activities. Examples of management activities include:
- Setting policies and strategic direction
- Directing and accepting responsibility for the actions of employees in their routine, recurring duties
- Having custody of the entity’s assets
- Reporting to those charged with governance on management’s behalf
- Deciding which of the auditor’s or outside party’s recommendations to implement
- Accepting project management responsibility
- Accepting responsibility for the design, implementation, or maintenance of internal control
- Providing services that are intended to be used as the primary basis for management decisions that are significant to the subject matter of the audit
- Developing a performance measurement system for the audited entity when that system is material or significant to the subject matter of the audit
- Serving as a voting member of the entity’s management committee or board of directors
**Routine activities.** Auditors typically perform certain routine activities in connection with audits. Those activities are usually insignificant in terms of the time and resources they require, and do not usually result in a specific project or engagement or in the production of a report or other formal work product. The Yellow Book does not consider these activities to be nonaudit services. Examples of these activities include:

- Providing advice about an accounting matter as an ancillary part of an audit
- Researching and responding to technical questions on tax laws as a part of providing tax services
- Providing advice on routine business matters
- Educating the audited entity on matters that are within the auditor’s technical expertise
- Providing information, such as best practices or benchmarking studies, that is readily available to the auditor

However, certain other activities are considered to be nonaudit services. Auditors should evaluate those activities using the conceptual framework. These activities include:

- Financial statement preparation
- Cash to accrual conversions
- Preparing reconciliations

**Observation**

The Yellow Book requirement to evaluate financial statement preparation, cash to accrual conversions, and reconciliations goes beyond the current requirements of the AICPA’s Ethics Interpretation No. 101-3, *Nonattest Services.*

**Study Question**

4. An example of an activity that an auditor is always prohibited from performing for an audited entity is:

   a. Providing advice to the audited entity on routine business matters
   b. Educating the audited entity’s personnel on accounting matters
   c. Maintaining custody of audited entity assets
   d. Providing the audited entity with best practices information that is readily available to the auditor

**Considering Specific Nonaudit Services**

Some nonaudit services always impair independence, while others may be allowable under certain conditions.
Preparing accounting records and financial statements. Some services involving preparation of accounting records always impair independence. These include:

- Determining or changing journal entries, account codes, or classifications or other accounting records without management approval
- Authorizing or approving the entity’s transactions
- Preparing or making changes to source documents, such as the general ledger, purchase orders, payroll time records, and customer orders or contracts, without management approval
- Accepting responsibility for the preparation and fair presentation of financial statements that the auditor will subsequently audit

Other services related to accounting records may be allowable if they are not expressly prohibited, the requirements in the section captioned Requirements for Performing Nonaudit Services above are met, and significant threats to independence have been eliminated or reduced to an acceptable level by applying the safeguards. These include:

- Recording transactions for which management has determined or approved appropriate account classifications
- Posting coded transactions to the general ledger
- Preparing financial statements based on the trial balance
- Posting entries that have been approved by management to the entity’s trial balance
- Preparing account reconciliations that identify reconciling items for management’s evaluation
- Proposing standard, adjusting, or correcting journal entries or other changes affecting the financial statements provided that:
  - Management reviews and accepts the changes.
  - The auditor is satisfied that management understands their nature and impact.

Internal audit assistance by external auditors. Assisting an entity in performing its internal audit activities always impairs independence when the external auditor:

- Sets internal audit policies or strategic direction
- Performs procedures that are a part of internal control, such as reviewing and approving changes to employee data access privileges
- Determines the scope of internal auditing.

Internal control monitoring. Performing or supervising ongoing monitoring procedures on behalf of management impairs the auditor’s independence.
IT systems service. Information technology (IT) services that impair an audit organization’s independence include:

- Designing or developing an IT system that will play a significant role in the management of an area that is or will be the subject of an audit
- Making other than insignificant modifications to the source code underlying such a system
- Operating or supervising the operation of such a system

Valuation services. Providing valuation services impairs an audit organization’s independence when:

- The valuations would materially affect, either separately or in the aggregate, the financial statements or other subject matter of the audit, and
- The valuation involves a significant degree of subjectivity.

Other nonaudit services. The following nonaudit services always impair independence:

- Non-tax disbursements:
  - Accepting responsibility for authorizing payment of entity funds
  - Accepting responsibility for signing or cosigning entity check, even if only in emergencies
  - Maintaining an audited entity’s bank account
  - Otherwise having custody of an audited entity’s funds
  - Making credit or banking decisions for the audited entity
  - Approving invoices for payment

- Benefit plan administration:
  - Making policy decisions on management’s behalf
  - Interpreting the plan document to participants on management’s behalf without first obtaining management’s concurrence
  - Making disbursements on the plan’s behalf
  - Having custody of plan assets

- Investment—advisory or management:
  - Making investment decisions on management’s behalf
  - Otherwise having discretionary authority over the entity’s investments
  - Executing buy or sell transactions for the entity’s investments
  - Having custody of assets, such as taking temporary possession of securities purchased by an audited entity

- Corporate finance—consulting or advisory:
  - Committing the entity to the terms of a transaction
  - Consummating a transaction on behalf of the entity
  - Acting as promoter, underwriter, broker-dealer, or guarantor of audited entity securities
  - Distributing private placement memoranda or offering documents of the audited entity
Executive or employee personnel matters:
- Committing the entity to employee compensation or benefit arrangements
- Hiring or firing entity employees

Business risk consulting:
- Making or approving business risk decisions
- Presenting business risk considerations to persons charged with governance, or to others, on management’s behalf

STUDY QUESTION

5. Provided that certain conditions are met, auditors may perform nonaudit services related to accounting records including all of the following except:
   a. Preparing account reconciliations that identify reconciling items for management’s evaluation
   b. Making disbursements on behalf of the audited entity’s employee benefit plan
   c. Posting entries that have been approved by management to the entity’s trial balance
   d. Recording transactions for which management has approved appropriate account classifications

DOCUMENTATION

Once safeguards are applied to reduce or mitigate the threat level, documentation is required. Documentation should address how the safeguard mitigates the threat. This documentation should include:

- The specific threats to independence that require application of the safeguards
- The safeguards applied
- Certain specific safeguards as specified in the Yellow Book if the audit organization is structurally located within a government entity and is considered independent based on those safeguards
- Consideration of whether management has suitable skill, knowledge, or experience to oversee nonaudit services. This documentation requirement is in excess of GAAS.
- An understanding with management or those charged with governance about nonaudit services, to include the:
  - Objectives of the nonaudit services
  - Services to be performed
  - Audited entity’s acceptance of its responsibilities
  - Auditor’s responsibilities
  - Any limitations of the nonaudit services
STUDY QUESTION

6. Which of the following is a documentation requirement of Government Auditing Standards that exceeds the requirements of GAAS?
   a. Documentation of an understanding with management or those charged with governance about the entity’s acceptance of its responsibilities with respect to nonaudit services
   b. Documentation of threats to independence that do not rise to an unacceptable level
   c. Documentation of the auditor’s consideration of whether the audited entity’s management has suitable knowledge, experience, or skill to oversee nonaudit services
   d. Documentation of the objectives of nonaudit services
MODULE 1: GOVERNMENT AUDITING STANDARDS — CHAPTER 2

Financial Audits

LEARNING OBJECTIVES

Upon completion of this chapter, the reader should be able to:

- Identify and explain the additional requirements of Government Auditing Standards for financial audits that go beyond the requirements of generally accepted auditing standards
- Explain the additional requirements related to detecting and reporting on fraud, noncompliance, and abuse
- Explain how to develop the elements of a finding
- Identify the additional reporting requirements for financial audits
- List additional documentation requirements

INTRODUCTION

The 2012 update for Government Auditing Standards (also referred to as the “Yellow Book” or “generally accepted governmental auditing standards” (GAGAS)) has not added significant new requirements for financial audits. It has focused, where practical, on incorporating the American Institute of Certified Public Accountants’ (AICPA’s) clarified Statements on Auditing Standards (SASs), and on eliminating unnecessary differences between the two sets of standards. It has also identified the additional requirements of GAGAS that go beyond the requirements of generally accepted auditing standards (GAAS). Those additional requirements are the focus of this chapter.

The new Yellow Book is effective for audits of financial statement periods ended on or after December 15, 2012. Early implementation is not permitted.

OBSERVATION

While early implementation is not permitted, firms are not, on the other hand, prohibited from selectively implementing some of the provisions of the new Yellow Book, as long as all of the requirements of the current Yellow Book continue to be observed through the effective date of the new publication. Some firms are doing this as a “test run” to forestall implementation problems after the effective date.
DEFINITIONS

The Yellow Book defines the following terms, which are relevant to this chapter.

Financial Audits

Financial audits performed in accordance with GAGAS include financial statement audits, and other related financial audits.

Financial statement audits. A financial statement audit is primarily intended to provide an opinion about whether an entity’s financial statements are presented fairly in all material respects in conformity with an applicable financial reporting framework, or “basis of accounting.” Reporting on financial statement audits under GAGAS includes an additional report on internal control over financial reporting and on compliance with provisions of laws, regulations, contracts, and grant agreements that have a material effect on the financial statements.

Other types of financial audits. Other types of financial audits conducted in accordance with GAGAS involve varying scopes of work. These include:

- Obtaining sufficient appropriate evidence to form an opinion on:
  - Single financial statements
  - Elements, accounts, or items of a financial statement
- Issuing letters for underwriters and certain other requesting parties
- Auditing compliance with applicable compliance requirements relating to government programs

Terminology Defining GAGAS Requirements

The Yellow Book’s terminology is consistent with that of GAAS. Unconditional requirements are indicated by the word must, and presumptively mandatory requirements by the word should. Not every paragraph of the Yellow Book contains a requirement.

RELATIONSHIP BETWEEN GAGAS AND OTHER PROFESSIONAL STANDARDS

Auditors may use GAGAS in conjunction with the professional standards of other authoritative bodies for financial audits, as follows:

- U.S. GAAS, established by the AICPA is incorporated into GAGAS by reference.
- Auditors may elect to use the International Standards on Auditing, and the International Standards on Assurance Engagements established by the International Auditing and Assurance Standards Board.
Auditors may elect to use the standards of the Public Company Accounting Oversight Board.

**ADDITIONAL REQUIREMENTS**

GAGAS establishes requirements for financial audits in addition to the requirements of GAAS. Those requirements are summarized below.

**Auditor Communication**

Auditors should communicate pertinent information that in their judgment needs to be communicated to:

- Individuals contracting for or requesting the audit
- Cognizant legislative committees when performing the audit:
  - Pursuant to law or regulation
  - For the legislative committee that has oversight of the audited entity

This requirement, however, does not apply to audits performed under the Single Audit Act, or in other circumstances where the law or regulation does not specifically identify the entities to be audited.

When it is not clearly evident who the persons charged with governance are, auditors should document the process followed and conclusions reached to identify who will receive the required auditor communications.

**Previous Audits and Attestation Engagements**

Auditors should do all of the following with respect to previous audit and attestation engagements:

- Ask management, when planning the audit, to identify previous audits, attestation engagements, and other studies that relate directly to the audit objectives, including whether their recommendations have been implemented.
- Evaluate whether appropriate corrective actions have been taken to address findings and recommendations from those engagements that could have a material effect on the financial statements or other significant financial data related to the audit objectives.
- Use the information obtained in assessing risk and determining the nature, timing, and extent of the current audit work, including determining to what extent it is necessary to test implementation of corrective actions that affect the current audit’s objectives.

**Fraud, Noncompliance, and Abuse**

The Yellow Book sets forth additional requirements related to fraud, noncompliance and abuse. Those requirements are summarized below.
Fraud and noncompliance. In addition to the AICPA requirements related to fraud and noncompliance with laws and regulations, auditors should apply those requirements to the consideration of compliance with the provisions of contracts or grant agreements.

Abuse. Abuse does not necessarily entail fraud or noncompliance. Rather, it is behavior that is improper or deficient compared to what a prudent person would consider reasonable and necessary business practice given the facts and circumstances. It also includes misuse of authority or position for personal, family, or business financial interests.

Auditors are not required to detect abuse in financial audits. However, if they become aware of abuse that could be material, in either a quantitative or a qualitative sense, they should apply audit procedures specifically directed toward ascertaining its effects on the financial statements or financial data subject to audit. That work may lead to the discovery of fraud or abuse.

It is important for auditors to avoid interference with investigations or legal proceedings in pursuing indications of fraud, noncompliance, or abuse. Auditors should evaluate the impact of investigations or legal proceedings on the current audit. The following considerations may apply:

- Law, regulation, or policy may require auditors to report certain types of fraud, noncompliance, or abuse to law enforcement or investigatory authorities before performing additional audit procedures.
- It may in some cases be appropriate to work with investigators or legal authorities.
- It may in some cases be appropriate to withdraw from or defer further work on the audit, or a portion of it, to avoid interference with an investigation or legal proceeding.

STUDY QUESTION

1. Which of the following statements about fraud and abuse is correct, according to the Yellow Book?

   a. Auditors are required to detect abuse in financial audits.
   b. Auditors should apply the AICPA’s requirements related to fraud and noncompliance with laws and regulations to the consideration of compliance with the provisions of contracts or grant agreements.
   c. Abuse necessarily entails fraud or noncompliance.
   d. Abuse does not include misuse of authority.

Developing Elements of a Finding

Findings in a financial audit may involve deficiencies in internal control, noncompliance, fraud, or abuse. Auditors should plan and perform
procedures to develop the elements of findings that are necessary to achieve the audit objectives. The Yellow Book lists those elements as follows.

**Criteria.** Criteria identify the required, expected, or desired state with respect to a program or operation. They provide a context for evaluating evidence and understanding findings. Criteria consist of:
- Laws and regulations
- Contracts or grant agreements
- Standards or measures
- Expected performance
- Defined business practices
- Benchmarks

**Condition.** A condition is the situation as it exists. A condition is determined and documented during the audit.

**Cause.** The cause identifies reasons or explanations for the condition, and factors accounting for the differences between the criteria and the condition. These factors often include:
- Poorly designed policies, procedures, or criteria
- Inconsistent, incorrect, or incomplete implementation
- Factors beyond the control of program management

These factors may serve as a basis for recommendations or corrective actions.

**Effect or potential effect.** The effect is a clear and logical link that establishes the impact or potential impact of the difference between the criteria and the condition. It identifies the outcomes or consequences of the condition, and may be used to demonstrate the need for corrective action.

Auditors should report their findings using these elements. They should place their findings in perspective by describing the nature and extent of the issues reported, and the extent of audit work performed. When appropriate, auditors should relate the instances identified to the population or number of cases examined, and quantify the results in monetary or other form.

**OBSERVATION**

In 2007 the President’s Council on Integrity and Efficiency released its *Report on National Single Audit Sampling Project*. This report noted that missing audit finding information was a common deficiency among the audits that it selected for sampling. It stated that one or more of the required elements were not included in many of the findings. This signals to the profession that federal regulators expect to see each of the above elements written explicitly into each audit finding.
STUDY QUESTION

2. Which of the following statements best applies to the elements of a finding?

   a. Factors that are outside of management’s control should not be considered in developing the cause element of a finding.

   b. The effect element of a finding identifies reasons or explanations for the condition, and factors accounting for the differences between the criteria and the condition.

   c. The effect element of a finding is a clear and logical link that establishes the impact or potential impact of the difference between the existing situation and the expected, desired, or required state.

   d. The condition element of a finding provides a context for evaluating evidence and understanding findings.

Documentation

In a GAGAS audit, auditors should comply with the following requirements which are in addition to the requirements of GAAS:

- Document, before the report release date, supervisory review of evidence supporting the findings, conclusions, and recommendations in the auditor’s report.

- Document any departures from GAGAS, and the impact of those departures on the auditor’s conclusions, due to:
  - Law or regulation
  - Scope limitations
  - Restrictions on access to records
  - Other issues impacting the audit.

- Make appropriate individuals and audit documentation available to other auditors or reviewers upon request.

Reporting on Financial Audits

GAGAS contains the following reporting requirements in addition to those in GAAS:

Reporting on auditor’s compliance with GAGAS. Auditors should include a statement in the auditor’s report that the audit was performed in accordance with GAGAS. Since GAGAS incorporates GAAS by reference, it is not necessary to cite compliance with GAAS in a GAGAS report. GAGAS does not prohibit auditors from issuing separate reports conforming only to GAAS or other standards.

Reporting on internal control and compliance. Auditors should also:

- Report on internal control over financial reporting.
- Report on compliance with provisions of laws, regulations, contracts, or grant agreements that have a material effect on the financial statements.
Include either in the same or a separate report a description of the scope of the auditor’s testing of internal control and compliance.

State in the report whether the tests performed provided sufficient appropriate evidence to support opinions on the effectiveness of internal control and on compliance.

When auditors report separately on internal control over financial reporting and on compliance, they should:
- State in the report on the financial statements that they are issuing those additional reports.
- Include a reference to the separate reports.
- State that the additional reports are an integral part of a GAGAS audit in considering the entity’s internal control over financial reporting and compliance.

**OBSERVATION**

The Yellow Book notes that the objective of the GAGAS requirement for reporting on internal control differs from that of an examination of internal control in accordance with the AICPA’s Statements on Standards for Attestation Engagements. The objective of the AICPA standard is to express an opinion on the design, or on both the design and operating effectiveness of internal control. When an auditor issues such an opinion, it is deemed to satisfy the GAGAS reporting requirement.

**Communicating deficiencies in internal control, fraud, noncompliance and abuse.** Auditors should communicate the following in the report on internal control and compliance:
- Significant deficiencies and material weaknesses in internal control.
- Material instances of fraud.
- Material noncompliance with laws or regulations.
- Material noncompliance with provisions of contracts or grant agreements.
- Material instances of abuse.
- Other instances that merit the attention of those charged with governance.

Findings that are less than material, but warrant the attention of those charged with governance should be communicated in writing. Communication of matters that do not merit the attention of those charged with governance is left to the auditor’s professional judgment.

Auditors should report known or likely fraud, noncompliance or abuse directly to outside parties when audited entity’s management fails to:
- Make communications to external parties that are required by law or regulation, and the auditors have first communicated the failure to those charged with governance.
Take timely and appropriate action to respond to known or likely fraud, noncompliance or abuse, and the auditors have first communicated the failure to those charged with governance.

These reporting requirements are in addition to any legal reporting requirements, and should be complied with even if the auditors have been dismissed or have resigned.

Auditors are also required to obtain sufficient appropriate evidence to corroborate management’s assertion that they have properly reported fraud, noncompliance or abuse to external parties. Confirmation from those parties is one form of such evidence. When auditors are not able to obtain this evidence, they should report directly to the external parties as discussed above.

**Reporting views of responsible officials.** Auditors should obtain and report the views of responsible officials of the audited entity concerning findings, conclusions, recommendations, and corrective actions. Oral comments are acceptable, but written comments are preferred.

A copy of the audited entity’s written comments, or a summary of them, should be included in the auditor’s report. When only oral comments are provided, the auditor should summarize them in the report, and provide a copy to the responsible officials to verify its accuracy.

Auditors should include an evaluation of the entity’s comments in the report, as appropriate. When those comments are inconsistent or in conflict with the draft audit report, or when corrective actions do not adequately address the audit recommendations, auditors should evaluate the validity of those comments. They should explain disagreements in the report. Conversely, when they find the comments to be valid, and supported by sufficient appropriate evidence, auditors should revise the report as necessary.

When the audited entity does not provide comments within a reasonable time, or refuses to comment, auditors may issue a report without receiving comments. In this case, the report should state that the entity did not provide comments.

**Reporting confidential or sensitive information.** GAGAS audits may involve pertinent information that is prohibited from public disclosure, or that is excluded due to its confidential or sensitive nature. In these cases, auditors should disclose in the report:

- That certain information has been omitted
- The reason or other circumstances that make the omission necessary

Auditors may issue a separate, classified, or limited-use report containing classified information or information that is otherwise prohibited by law or regulation from general disclosure. Such a report is distributed only to persons authorized to receive that information.
Other non-classified information, such as computer security or matters involving public safety, privacy, or security concerns, may also be justifiably excluded from a publicly available report. Auditors may, in this case, issue a limited-use report for distribution only to parties responsible for acting on its recommendations.

Auditors should consider whether omissions of information could distort the audit results, or conceal illegal or improper practices.

When subject to public records laws, auditors should determine whether those laws could affect the availability of classified or limited-use reports. They should determine if other means of communication with management or those charged with governance would be more appropriate in these instances. This might include communicating general information in a written report and detailed information orally.

**Distributing reports.** Distribution of GAGAS reports depends on the relationship of the auditors and the audited entity, and the nature of the information in the report. The following are requirements related to report distribution:

- Auditors should document any limitations on report distribution.
- Audit organizations in government should distribute reports to:
  - Those charged with governance
  - Appropriate entity officials
  - Appropriate oversight bodies requiring or arranging for the audit
  - Other appropriate officials with legal oversight authority or with responsibility for acting on audit findings
  - Others authorized to receive such reports.
- For internal audit organizations in government, the head of the organization should communicate audit results to parties who can ensure that the results receive due consideration.
- Unless otherwise required by law or regulation, the head of the internal audit organization should, before releasing results to outside parties:
  - Assess the potential risk to the organization
  - Consult with senior management as appropriate
  - Control report dissemination by indicating the intended users in the report.
- Public accounting firms engaged to perform GAGAS audits should clarify report distribution responsibilities with the engaging organization. If the accounting firm is responsible for report distribution, it should obtain an agreement about which officials or organizations are to receive the report, and the steps taken to make it publicly available.
STUDY QUESTION

3. Which of the following statements applies to the auditor’s additional reporting responsibilities under GAGAS?
   
   a. GAGAS prohibits auditors from issuing separate reports conforming only to GAAS.
   
   b. Auditors are prohibited from issuing a report when the audited entity refuses to comment on audit findings.
   
   c. Findings that are less than material, but warrant the attention of those charged with governance may be communicated either in writing or orally.
   
   d. Auditors may issue a separate, limited-use or classified report containing classified information or information that is otherwise prohibited by law or regulation from general disclosure.

Additional Considerations for Financial Audits

Because of the objectives and public accountability aspects of a GAGAS audit, additional considerations may apply. These are not, however, requirements.

Materiality. It may be appropriate to use lower levels of materiality compared to GAAS audits, due to public accountability considerations, legal and regulatory requirements, and the sensitivity and visibility of government programs.

Early communication of deficiencies. Early communication of deficiencies to management or those charged with governance may be important due to their relative significance and the urgency of corrective action. It is also important, when a control deficiency results in noncompliance or abuse, to make early communication in order to prevent further noncompliance.
MODULE 1: GOVERNMENT AUDITING STANDARDS — CHAPTER 3

Performance Audits

LEARNING OBJECTIVES

Upon completion of this chapter, the reader should be able to:

- Identify changes to previous standards related to performance audits
- Determine required procedures to apply during the field work in performance audits
- Identify documentation requirements for performance audits
- Explain the reporting requirements for performance audits

INTRODUCTION

The 2011 update for Government Auditing Standards (also referred to as the “Yellow Book” or “generally accepted governmental auditing standards” or GAGAS) has brought only minor changes to existing requirements for performance audits. This chapter presents an overview of those requirements.

The field work standards for performance audits are covered in Chapter 6, and the reporting standards in Chapter 7 of the new Yellow Book. The requirements of Chapters 1–3, covering the foundation and ethical principles of government auditing, the standards for use and application of GAGAS, and the general standards, which include independence, also apply to performance audits.

The new Yellow Book is effective for performance audits beginning on or after December 15, 2011.

CHANGES RELATED TO PERFORMANCE AUDITS

The new Yellow Book contains the following changes to existing standards:

- The discussion of validity as an aspect of the quality of evidence has been revised. This revision appears in the “Definitions” section of this chapter.
- The discussion of the assessment of sufficiency and appropriateness of computer-processed information has been revised to indicate that it includes considerations related to the completeness and accuracy of the data for its intended purpose.
- The fraud reporting requirement has been limited to occurrences that are significant to the audit objectives.
- A requirement has been added to communicate in writing other instances of fraud that warrant the attention of those charged with governance.
The requirement for audit organizations to develop policies to address requests by outside parties for access to audit documentation has been deleted.

A consideration that auditors may follow for early communication of deficiencies has been added.

DEFINITIONS
The new Yellow Book defines the following terms that are relevant to performance audits:

Abuse
Abuse is behavior that is deficient or improper compared to behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances.

Appropriateness
Appropriateness is the measure of the quality of evidence. It encompasses the following elements that are used for addressing audit objectives and supporting findings and conclusions:

Relevance
Relevance refers to the extent to which evidence has a logical relationship with, and importance to, the issue being addressed.

Validity
Validity refers to the extent to which evidence represents what it purports to represent. That is, the extent to which it provides a reasonable or meaningful basis for measuring what is being evaluated.

Reliability
Reliability refers to the consistency of results when information is measured or tested. It includes the concepts of being verifiable or supported.

Audit Risk
Audit risk is the possibility that the auditor’s findings, conclusions, recommendations, or assurance may be incomplete or improper, as a consequence of such factors as insufficient or inappropriate evidence, inadequate audit process, or intentional omissions or misleading information as a result of fraud or misrepresentation.
Significance
Significance is the relative importance of a matter within the context in which it is being considered. It is comparable to the term “materiality” as it applies to financial audits. Significance includes quantitative and qualitative factors, such as:
- Magnitude
- Nature and effect
- Relevance
- Needs and interests of an objective third party with knowledge of relevant information
- Impact of the matter on the program or activity

Sufficiency
Sufficiency is a measure of the quality of evidence used for addressing the audit objectives and supporting findings and conclusions. It also depends on the appropriateness of the evidence.

Terminology Defining GAGAS Requirements
The Yellow Book’s terminology is consistent with that of GAAS. Unconditional requirements are indicated by the word must, and presumptively mandatory requirements by the word should. Not every paragraph of the Yellow Book contains a requirement.

STUDY QUESTION

1. The Yellow Book defines the term validity, as it applies to evidence in a performance audit, as:
   a. The consistency of results when information is measured or tested
   b. The extent to which evidence represents what it purports to represent
   c. The extent to which evidence has a logical relationship with the issue being addressed
   d. A measure of the quality of evidence used for addressing the audit objectives

FIELD WORK STANDARDS FOR PERFORMANCE AUDITS
Chapter 6 of the new Yellow Book contains the field work standards for performance audits. The concepts of reasonable assurance, significance, and audit risk form a framework for applying these standards.

Reasonable Assurance
In performance audits under GAGAS, auditors obtain reasonable assurance that evidence is sufficient and appropriate, as defined above, to support
the audit’s findings and conclusions. The objectives for performance audits vary greatly. For this reason, the sufficiency and appropriateness of evidence needed and tests of evidence will vary depending on the objectives, findings, and conclusions of the audit. The Supplemental Guidance in Appendix I to the Yellow Book contains detailed discussion and examples of performance audit objectives.

Planning

The introduction to this section contains two unconditional requirements. They state that auditors must:

- Plan and document the planning of the work necessary to address the audit objectives
- Plan the audit to reduce audit risk to a level appropriate for the auditor to obtain reasonable assurance that the evidence is sufficient and appropriate to support the findings and conclusions

The introduction to this section contains three presumptively mandatory requirements. They state that the auditor should:

- Design the audit methodology to obtain reasonable assurance that the evidence is sufficient and appropriate to:
  - Support the audit findings and conclusions in relation to its objectives
  - Reduce audit risk to an acceptable level
- Assess audit risk and significance within the context of the audit’s objectives
- Also do the following during planning:
  - Identify potential criteria to evaluate the subject matter of the audit
  - Identify sources of audit evidence
  - Determine the amount and type of evidence needed
  - Evaluate whether to use the work of specialists or other auditors
  - Assign sufficient staff and specialists to perform the audit
  - Communicate about planning and performance of the audit to management, those charged with governance, and others as applicable
  - Prepare a written audit plan

Nature and profile of the program and user needs. This subsection states that auditors should obtain an understanding of the nature of the program to be audited, and the potential use that is to be made of the audit results. This includes:

- Visibility, sensitivity, and relevant risks associated with the program
- Age of the program
- Changes in program conditions
- Program size in dollars, number of persons affected, or other measures
Level and extent of review or other forms of independent oversight
Program’s strategic plan and objectives
External conditions or factors that could have a direct effect on the program

Understanding the potential users of the auditor’s report is also important, because they may have the ability to influence the conduct of the program. Awareness of their interests and influence helps the auditor to judge the significance of findings.

Obtaining an understanding of the program also helps auditors to assess risk and its effect on the audit. Individual aspects of this understanding may include:
- Laws and regulations
- Contracts and grant agreements
- Program purpose and goals
- Internal controls
- Program inputs, or the resources that are put into the program
- Program operations, which are the methods or activities that program management uses to convert inputs into outputs
- Outputs, or the quantity of goods and services produced by the program
- Outcomes, or the results and accomplishments of the program

**Internal control.** This subsection states that auditors should:
- Obtain an understanding of internal control that is significant within the context of the audit objectives
- Assess whether significant internal control has been properly designed and implemented
- Perform procedures to obtain sufficient, appropriate evidence to support the assessment of the effectiveness of internal control
- Determine whether it is necessary to evaluate information system controls

A deficiency in internal control exists in a performance audit when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct on a timely basis:
- Impairments of the efficiency or effectiveness of operations
- Misstatements in financial performance information
- Noncompliance with laws, regulations, contracts, or grant agreements

A design deficiency exists when:
- A necessary control is missing, or
- An existing control, even when operating as designed, does not meet the control objective.
A deficiency in operation exists when:
- A properly designed control does not operate as designed, or
- The person performing the control does not have necessary qualifications or authority to perform it effectively.

**Information system controls.** This subsection requires that auditors should:
- Obtain a sufficient understanding of information systems controls necessary to assess audit risk and to plan the audit within the context of the audit objectives
- Determine which audit procedures relevant to information systems controls are necessary to obtain sufficient appropriate evidence to support the audit’s findings and conclusions

**Provisions of laws, regulations, contracts, and grant agreements.** This subsection requires that auditors should:
- Identify provisions of laws, regulations, contracts, or grant agreements that are significant within the context of the audit objectives
- Assess the risk that noncompliance with those provisions could occur
- Design and perform procedures to obtain reasonable assurance of detecting significant noncompliance

**Fraud.** This subsection requires that auditors should:
- Assess the risks that significant fraud could occur
- Discuss fraud risk among audit team members
- Gather and assess information to identify significant fraud risks
- Design procedures to obtain reasonable assurance of detecting significant fraud
- When information coming to the auditor’s attention indicates that significant fraud may have occurred:
  - Determine whether fraud has likely occurred, and if so,
  - Determine its effects on the audit findings.

This subsection emphasizes that the determination of whether fraud has actually occurred is beyond the auditor’s professional responsibility. Whether an act is in fact fraudulent can only be determined through the judicial system.

**Abuse.** This subsection requires that auditors should, if they become aware of abuse that could be quantitatively or qualitatively significant, apply procedures to ascertain its potential effect. It emphasizes, however, that the determination of abuse is subjective, and that auditors are not required to detect abuse in performance audits.
STUDY QUESTION

2. Which of the following is one of the auditor’s responsibilities with respect to fraud and abuse?
   a. The auditor is responsible for determining if fraud has actually occurred.
   b. The auditor is responsible for designing audit procedures specifically targeted at detecting abuse.
   c. The auditor is responsible for reporting suspected fraud or abuse directly to law enforcement officials.
   d. The auditor is responsible for gathering information to identify significant fraud risks.

Ongoing investigations and legal proceedings. Auditors should evaluate the impact of investigations or legal proceedings on the current audit. It is important to avoid interfering with investigations or legal proceedings in pursuing indications of fraud, noncompliance, or abuse. The following considerations may apply:

- Law, regulation, or policy may require auditors to report certain types of fraud, noncompliance, or abuse to law enforcement or investigatory authorities before performing additional audit procedures.
- It may in some cases be appropriate to work with investigators or legal authorities.
- It may in some cases be appropriate to withdraw from or defer further work on the audit, or a portion of it, to avoid interference with an investigation or legal proceeding.

Previous audits and attestation engagements. Auditors should do all of the following with respect to previous audit and attestation engagements:

- Ask management, when planning the audit, to identify previous audits, attestation engagements, and other studies that relate directly to the audit objectives, including whether their recommendations have been implemented.
- Evaluate whether appropriate corrective actions have been taken to address findings and recommendations from those engagements that could have a material effect on the financial statements or other significant financial data related to the audit objectives.
- Use the information obtained in assessing risk and determining the nature, timing, and extent of the current audit work, including determining to what extent it is necessary to test implementation of corrective actions that affect the current audit’s objectives.
Identifying audit criteria. This subsection requires that auditors should identify criteria. Criteria identify the required or desired state or expectation for the program or operation. They also provide a context for evaluating evidence and understanding audit findings, conclusions, and recommendations. These criteria should be relevant to audit objectives and permit consistent assessment of the subject matter, and may include:

- Laws and regulations
- Contracts and grant agreements
- Standards
- Specific requirements
- Measures
- Expected performance
- Defined business practices
- Benchmarks

Identifying evidence. This subsection requires that auditors should:

- Identify potential sources of information that could be used as evidence
- Determine the amount and type of evidence necessary to provide sufficient, appropriate evidence to address audit objectives and adequately plan the audit
- Evaluate whether the lack of sufficient, appropriate evidence is due to internal control deficiencies, or other program weaknesses
- Evaluate whether the lack of sufficient, appropriate evidence could form a basis for audit findings

Using the work of others. This subsection requires that auditors should:

- Determine whether other auditors have conducted or are conducting audits of the program that could be relevant to current audit objectives
- If using the work of other auditors, perform procedures that provide sufficient basis for using that work, including:
  - Obtaining evidence about the other auditors’ independence and qualifications
  - Whether the scope, quality, and timing of their work is adequate for reliance within the context of the current audit’s objectives.
- Assess the independence and professional qualifications of any specialists used in the audit.

Assigning staff and other resources. This subsection states that audit management should:

- Assign sufficient staff and specialists with adequate collective professional competence to perform the audit.
- If using a specialist, document the nature and scope of the work to be performed by the specialist, including its:
Objectives and scope
Intended use
Procedures and findings
Assumptions and methods

Communicating with management, those charged with governance, and others. This subsection requires that auditors should communicate an overview of the audit’s objectives, scope, methodology, timing, and planned reporting to:

- Management
- Those charged with governance
- The individuals contracting for or requesting the audit
- Cognizant legislative committees

Auditors should document this communication. They may do this with an engagement letter, but are not required to do so.

This requirement, however, does not apply when making that communication could significantly impair the auditor’s ability to obtain audit evidence, such as for unannounced cash counts or in cases of suspected fraud.

When the identities of those charged with governance is not readily evident, auditors should document the process followed and conclusions reached in determining who should receive required audit communications.

When an audit is terminated before completion and a report is not issued, auditors should document:

- The results of the audit to the date of termination
- The reason for termination

STUDY QUESTION

3. Auditors should communicate an overview of the audit’s objectives, scope, methodology, timing, and planned reporting:

   a. In an engagement letter
   b. To management and those charged with governance
   c. To regulators charged with program oversight
   d. In cases of suspected fraud

Preparing a written audit plan. This subsection of the Yellow Book contains an unconditional requirement that auditors must prepare a written audit plan for each audit. They should update that plan as necessary to reflect any significant changes made during the audit.
Supervision

This section of the Yellow Book contains an unconditional requirement that audit supervisors or those designated to supervise auditors must properly supervise audit staff. The nature and extent of this supervision may vary depending upon factors such as the experience of the staff and size of the audit.

Obtaining Sufficient, Appropriate Evidence

This section of the Yellow Book states an unconditional requirement that auditors must obtain sufficient, appropriate evidence to provide a reasonable basis for their findings and conclusions. In assessing evidence, they should evaluate whether the evidence as a whole is sufficient and appropriate for addressing the audit’s objectives and supporting its findings and conclusions.

Appropriateness. This subsection states that auditors should:

- Evaluate the objectivity, credibility, and reliability of testimonial evidence
- Determine what the officials of the audited entity did to obtain assurance of the reliability of information when the auditors make use of that information
- Assess the sufficiency and appropriateness of computer-processed information

This subsection contains a useful discussion on the strengths and weaknesses of evidence obtained by observation, inquiry, or inspection. It states that, in general:

- Evidence obtained under conditions of effective internal control is more reliable than evidence obtained under ineffective controls.
- Evidence obtained by direct auditor observation, inspection, computation, or physical examination is more reliable than evidence obtained indirectly.
- Examination of original documents is more reliable than examination of copies.
- Testimonial evidence obtained under conditions in which persons may speak freely is more reliable than evidence obtained in circumstances in which the person may be intimidated.
- Testimonial evidence obtained from a knowledgeable, unbiased person is more reliable than evidence obtained from one who is biased or has indirect or incomplete knowledge.
- Evidence obtained from a knowledgeable, credible, unbiased third party is more reliable than evidence obtained from management or others with a direct interest in the audited entity.
**Sufficiency.** This subsection requires that auditors should determine whether there is enough appropriate evidence to address audit objectives and to support audit findings and conclusions.

While this determination is a matter of professional judgment, the Yellow Book notes that:
- The greater the audit risk, the greater the quality and quantity of evidence required.
- Stronger evidence may permit less evidence to be used.
- A large volume of evidence does not compensate for its lack of reliability, relevance, or validity.

**Overall assessment of evidence.** This subsection requires that auditors should:
- Determine the overall sufficiency and appropriateness of evidence to provide a reasonable basis for their findings and conclusions.
- Perform and document an overall assessment of the collective evidence used to support their findings and conclusions. This assessment includes the results of any specific assessments conducted to conclude on the reliability and validity of specific evidence.
- Evaluate the expected significance of evidence to the audit’s objectives, findings, conclusions, the available corroborating evidence, and the audit risk.

**Developing elements of a finding.** This subsection contains the requirement that auditors should plan and perform procedures to develop the elements of a finding necessary to address the audit objectives. It also lists and explains those elements.

- **Criteria.** Criteria are discussed in the section/subsection entitled *Planning/Identifying audit criteria*, above.

- **Condition.** A condition is the situation as it exists. A condition is determined and documented during the audit.

- **Cause.** The cause identifies reasons or explanations for the condition, and factors accounting for the differences between the criteria and the condition. These factors may serve as a basis for recommendations or corrective actions. They often include:
  - Poorly designed policies, procedures or criteria
  - Inconsistent, incorrect or incomplete implementation
  - Factors beyond the control of program management

- **Effect or potential effect.** The effect is a clear and logical link that establishes the impact or potential impact of the difference between the criteria and the condition. It identifies the outcomes or consequences of the condition, and may be used to demonstrate the need for corrective action.
Auditors should report their findings using these elements. They should place their findings in perspective by describing the nature and extent of the issues reported, and the extent of audit work performed. When appropriate, auditors should relate the instances identified to the population or number of cases examined, and quantify the results in monetary or other form.

**OBSERVATION**

In 2007 the President’s Council on Integrity and Efficiency released its *Report on National Single Audit Sampling Project*. This report noted that missing audit finding information was a common deficiency among the audits that it selected for sampling. It stated that one or more of the required elements were not included in many of the findings. Although this report applies specifically to audits conducted under the Single Audit Act, it signals to the profession that federal regulators expect to see each of the above elements written explicitly into each audit finding.

**STUDY QUESTION**

4. All of the following are unconditional requirements *except*:

   a. Auditors must determine whether there is enough appropriate evidence to address audit objectives.
   
   b. Auditors must obtain sufficient, appropriate evidence to provide a reasonable basis for their conclusions.
   
   c. Audit staff must be properly supervised. Supervisors or those designated to supervise auditors must properly supervise audit staff.
   
   d. Auditors must prepare a written audit plan for each audit.

**Audit Documentation**

This section creates the unconditional requirement that auditors must prepare audit documentation related to planning, conducting and reporting for each audit. Auditors should also observe the following presumptively mandatory requirements:

- Prepare audit documentation in sufficient detail to enable an experienced auditor having no previous connection with the audit to understand the:
  - Nature, timing, extent and results of audit procedures performed
  - Audit evidence obtained and its source
  - Conclusions reached
  - Evidence supporting significant audit judgments and conclusions
- Prepare audit documentation that contains evidence that supports the findings, conclusions, and recommendations prior to report issuance
- Design the form and content of the audit documentation to meet the particular audit’s circumstances
Document the objectives, scope, and methodology of the audit.

Document the work performed and evidence obtained to support significant judgments and conclusions, including descriptions of records and transactions examined.

Document supervisory review, prior to report issuance, of evidence that supports the audit’s findings, conclusions, and recommendations.

Document any departures from GAGAS caused by law or regulation, scope limitations, or restrictions on access to records or other issues, and their impact on the audit and its conclusions.

Make audit documentation and appropriate individuals timely available to other auditors to satisfy the objectives of GAGAS.

OBSERVATION

The term experienced auditor, as used above, means a person who has the competencies and skills that would have enabled him or her to conduct the performance audit.

The requirement to document descriptions of transactions and records examined means listing them by identifying numbers or other characteristics such that they could be re-examined. Copies of those documents, or detailed listings of information from them is not, however, required.

REPORTING STANDARDS FOR PERFORMANCE AUDITS

Chapter 7 of the new Yellow Book contains the reporting requirements for performance audits. These requirements relate to the form of the report, and its contents, issuance, and distribution.

Reporting

This section states an unconditional requirement that auditors must issue audit reports communicating the results of each completed performance audit.

Auditors should also comply with the following presumptively mandatory requirements:

- Auditors should use a form of report that is appropriate for its intended use.
- The auditor’s report should be in writing or other retrievable form, such as written reports, letters, briefing slides, or other presentation materials.
- When an audit is terminated before completion, auditors should document the results of the work to the date of termination and the reasons for termination.
- If the auditors discover, subsequent to report issuance, that they did not have sufficient appropriate evidence to support the reported findings or conclusions, they should:
Communicate to those charged with governance, appropriate officials, and other known report users in the same manner that they used to distribute the original report
- Remove the report from their publicly accessible website, if it is posted there, and post a notification that it was removed
- Determine whether to conduct additional work necessary to reissue the report, including any revisions to findings or conclusions
- Re-post the original audit report if additional work does not lead to changed findings or conclusions

Report Contents
This section sets forth the requirement that auditors should prepare audit reports that contain:
- The audit’s objectives, scope, and methodology
- The audit’s results, including findings, conclusions, and recommendations as appropriate
- A statement about the auditor’s compliance with GAGAS
- A summary of the views of responsible officials
- The nature of any sensitive or confidential information omitted, where applicable

Objectives, scope, and methodology. This subsection requires that auditors should:
- Include in the report a description of the audit objectives and the scope and methodology for addressing those objectives
- Communicate audit objectives in the report in a clear, specific, neutral, and unbiased fashion that includes relevant assumptions
- State in the report that certain issues were outside the scope of the audit, when audit objectives are limited but broader objectives could be inferred by users
- Describe the scope of the work performed and any limitations, including issues relevant to likely users
- Report significant constraints imposed on the audit approach by information limitations, scope impairments, or excessive delays or denials of access to records or individuals
- Explain or identify, as applicable:
  - The relationship between the population and items tested
  - Organizations, locations, and time periods covered
  - The kinds and sources of evidence
  - Significant limitations or uncertainties
- Explain how the completed audit work supports the audit objectives
Identify or describe:
- Significant assumptions made in conducting the audit
- Comparative audit techniques applied
- Criteria used
- Sample design, including why the design was chosen and whether the results can be projected to the intended population

**Report findings.** This subsection requires that auditors should:
- Present sufficient, appropriate evidence to support their findings and conclusions in relation to the audit’s objectives
- Provide recommendations for corrective actions when they are able to sufficiently develop the elements of a finding
- Describe in the report limitations or uncertainties with the reliability of evidence, if that evidence is significant to the audit findings and conclusions and such a disclosure is needed to avoid misleading report users
- Place audit findings in perspective by describing the nature and extent of issues reported and the extent of the work performed that resulted in the finding
- Relate instances identified to the population or number of cases examined, and quantify the results in monetary or other form
- Disclose significant facts which, if not disclosed, could mislead knowledgeable report users
- Report significant internal control deficiencies and instances of fraud, noncompliance, or abuse that have occurred or are likely to have occurred

**Deficiencies in internal control.** According to this subsection, auditors should:
- Include the scope of their work on internal control in the audit report
- Include any internal control deficiencies that are significant within the context of the audit in the audit report
- Include any internal control deficiencies that are not significant to the audit objectives but still merit the attention of those charged with governance either in the audit report or in a separate written communication to audited entity officials
- Refer in the audit report to any such separate written communication

**Fraud, noncompliance, and abuse.** This subsection requires that auditors should:
- Report as a finding significant instances of known or likely fraud, noncompliance, or abuse that are supported by sufficient, appropriate evidence
- Communicate in writing to those charged with governance instances of fraud, noncompliance, or abuse that are not significant but that warrant their attention.
**Reporting findings directly to outside parties.** Auditors should report known or likely fraud, noncompliance, or abuse directly to outside parties when an audited entity’s management fails to:

- Make communications to external parties that are required by law or regulation, and the auditors have first communicated the failure to those charged with governance
- Take timely and appropriate action to respond to known or likely fraud, noncompliance, or abuse, and the auditors have first communicated the failure to those charged with governance

These reporting requirements are in addition to any legal reporting requirements, and should be complied with even if the auditors have been dismissed or have resigned.

Auditors are also required to obtain sufficient appropriate evidence to corroborate management’s assertion that they have properly reported fraud, noncompliance, or abuse to external parties. Confirmation from those parties is one form of such evidence. When auditors are not able to obtain this evidence, they should report directly to the external parties as discussed above.

**STUDY QUESTION**

5. Auditors should report known or likely fraud, noncompliance, or abuse that comes to their attention directly to outside parties under which of the following circumstances?

   a. When the audited entity’s management fails to make communications to external parties that are required by law or regulation, and prior to the auditor communicating the failure to those charged with governance
   
   b. When the audited entity’s management fails to take timely and appropriate action to respond to known noncompliance, and the auditors have first communicated the failure to those charged with governance
   
   c. After external parties have confirmed that the audited entity’s management has properly reported the fraud, noncompliance, or abuse
   
   d. After the auditors have resigned, unless otherwise prohibited by law or regulation

**Conclusions.** Auditors should report conclusions based upon the audit’s objectives and its findings.

**OBSERVATION**

The Yellow Book states that conclusions are logical inferences based on the auditors’ findings. They are not merely a summary of the findings.
**Recommendations.** This subsection states that auditors should comply with the following presumptively mandatory requirements:

- Recommend actions to correct deficiencies or other findings identified during the audit, or to improve programs and operations.
- Make recommendations that:
  - Flow logically from the findings and conclusions
  - Are directed at resolving the cause of the findings and deficiencies
  - Clearly state the actions recommended

**Reporting compliance with GAGAS.** This subsection presents the following presumptively mandatory requirements:

- When auditors comply with all applicable GAGAS requirements, they should include an unmodified GAGAS compliance statement in the audit report. The prescribed wording of this statement is reproduced in Exhibit 1 to this chapter.
- When auditors do not comply with all applicable GAGAS requirements, they should include a modified compliance statement in the audit report, which should either modify the language shown in Exhibit 1 to indicate which requirements were not followed, or should state that the auditor did not follow GAGAS.

**Reporting views of responsible officials.** This subsection requires that auditors should:

- Obtain and report the views of responsible officials of the audited entity concerning audit findings, conclusions, recommendations, and any planned corrective actions
- Include a copy of the officials’ written comments in their report
- Prepare a summary of the officials’ oral comments, when written comments are not provided
- Include an evaluation of the comments in the audit report, as appropriate
- Evaluate the entity’s comments in the report, as appropriate
- When the entity’s comments are inconsistent or in conflict with the draft audit report, or when corrective actions do not adequately address the audit recommendations, auditors should evaluate the validity of those comments and should explain disagreements in the report
- When auditors find the comments to be valid, and supported by sufficient appropriate evidence, they should revise the report as necessary
- When the audited entity does not provide comments within a reasonable time, or refuses to comment, auditors may issue a report without receiving comments. In this case, the report should state that the entity did not provide comments.


**STUDY QUESTION**

6. Which of the following statements best applies to the auditor’s responsibilities for reporting the views of responsible officials?

   a. Auditors are required to obtain written comments from responsible officials concerning their views about the audit’s findings.
   
   b. When the entity’s comments are in conflict with the draft audit report, auditors should require the entity to revise its comments.
   
   c. Auditors may not issue a report without receiving comments from the audited entity.
   
   d. Auditors should include an evaluation of the audited entity’s comments in the audit report, as appropriate.

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**Reporting confidential and sensitive information.** GAGAS audits may involve pertinent information that is prohibited from public disclosure, or that is excluded due to its confidential or sensitive nature. In these cases, auditors should disclose in the report:

- That certain information has been omitted
- The reason or other circumstances that make the omission necessary

Auditors may issue a separate, classified, or limited-use report containing classified information or information that is otherwise prohibited by law or regulation from general disclosure. Such a report is distributed only to persons authorized to receive that information.

Other nonclassified information, such as computer security, or matters involving public safety, privacy, or security concerns, may also be justifiably excluded from a publicly available report. Auditors may, in this case, issue a limited-use report for distribution only to parties responsible for acting on its recommendations.

Auditors should consider whether omissions of information could distort the audit results, or conceal illegal or improper practices.

When subject to public records laws, auditors should:

- Determine whether those laws could affect the availability of classified or limited-use reports
- Determine if other means of communication with management or those charged with governance would be more appropriate in these instances. This might include communicating general information in a written report, and detailed information orally.

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**Distributing Reports**

Distribution of GAGAS reports depends on the relationship of the auditors and the audited entity, and the nature of the information in the report. The following are requirements related to report distribution:

- Auditors should document any limitations on report distribution.
Audit organizations in government should distribute reports to:

- Those charged with governance
- Appropriate entity officials
- Appropriate oversight bodies requiring or arranging for the audit
- Other appropriate officials with legal oversight authority or with responsibility for acting on audit findings
- Others authorized to receive such reports.

For internal audit organizations in government, the head of the organization should communicate audit results to parties who can ensure that the results receive due consideration.

Unless otherwise required by law or regulation, the head of the internal audit organization should, before releasing results to outside parties:

- Assess the potential risk to the organization
- Consult with senior management as appropriate
- Control report dissemination by indicating the intended users in the report.

Public accounting firms engaged to perform GAGAS audits should clarify report distribution responsibilities with the engaging organization. If the accounting firm is responsible for report distribution, it should obtain an agreement about which officials or organizations are to receive the report, and the steps taken to make it publicly available.

EXHIBIT 1: UNMODIFIED GAGAS COMPLIANCE STATEMENT

The 2011 revision of Government Auditing Standards specifies the following standard language for an unmodified GAGAS compliance statement in a performance audit (paragraph 7.30):

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

CPE NOTE: When you have completed your study and review of chapters 1-3, which comprise Module 1, you may wish to take the Quizzer for this Module.

Go to CCHGroup.com/PrintCPE to take this Quizzer online.
MODULE 2: IMPLEMENTATION ISSUES — CHAPTER 4

Top Ten Implementation Issues—SSARS 19

LEARNING OBJECTIVES

Upon completion of this chapter, the reader should be able to:

- Recognize the two new key elements for compilation and review reports under SSARS 19
- Explain the requirements for obtaining an understanding with management in compilation and review engagements.
- List the minimum required management representations in a review engagement
- Describe the attributes of properly documented analytical procedures

INTRODUCTION

Statement on Standards for Accounting and Review Services No. 19, Compilation and Review Services (SSARS 19) became effective for financial statements with periods ending on or after December 15, 2010. This pronouncement brought with it the most sweeping changes to compilation and review practice in the last thirty years. A full annual financial statement cycle has now passed since the effective date. Some implementation issues in compilation and review engagements are now coming to the forefront. These issues involve:

- Reporting
- Performance
- Documentation

This course summarizes ten of the most prevalent problems that practitioners are having in implementing these new requirements, and offers solutions to them.

REPORTING

Issue No. 1: Failure to Adopt New Report Wording

Problem. Some firms still have not adopted the new report wording for compilations and reviews. For many firms, this was an initial-year implementation issue, in which the firm was aware of the change in the standard but did not fully understand the effective date. Other firms, particularly those that run primarily tax practices, and for whom financial statements are a by-product of the tax compliance process, have been unaware of the
change in standards. This is always a serious problem, because the new report wording contains significant changes from previous practice. This failure would cause a firm that has only a SSARS practice, and thus is required to have an engagement review under the AICPA’s peer review program, not to pass its peer review.

Two new elements are key to the revised report wording under SSARS 19. These are in keeping with the general philosophical thrust of an AICPA standard-setting initiative in recent years, which seeks to draw a bright line between management’s responsibilities and the CPA’s responsibilities.

- **Management’s responsibility.** In both compilation and review reports, the report should state that management is responsible for:
  - The preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States (or in accordance with another financial reporting framework, such as cash or tax basis)
  - Designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements

- **Accountant’s responsibility.** These responsibilities differ between compilation and review engagements.
  - In a both a compilation and a review, the accountant is responsible for conducting the engagement in accordance with SSARS.
  - In a review, the accountant is also responsible for performing procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements.

**Solutions.** All firms should make certain that they have read and understand the text of SSARS 19 that applies to the firm’s practice. This pronouncement contains a section for compilation engagements, and a section for review engagements. It is not necessary to read both sections unless the firm does both types of engagements. SSARS 19 contains example wording for the new compilation and review reports. This wording is significantly different from the old wording.

Firms that find they have issued compilation or review reports for years ending on or after December 15, 2010, that are not SSARS 19 compliant should consider recalling and reissuing those reports.

Many firms, especially those with high-volume monthly compilation practices, find that this is a simple problem of making certain that all of their reporting templates are properly updated. A comprehensive inspection of one full cycle of reports, before they are issued, should identify any noncompliant reports. Firms should give particular attention in this process to any engagements that have unusual aspects for the firm’s practice, and thus might pull their reporting out of the firm’s normal process.
Issue No. 2: Improper Dating of Review Reports

Problem. Improper report dating of review reports is surprisingly prevalent, yet seldom apparent to outside users of the report. It is detected only by comparing the dates on the review documentation to the report date. SSARS 19 states that the accountant’s report in a review engagement should be dated no earlier than the date on which accountant has amassed review evidence sufficient to provide a reasonable basis for the conclusion that the accountant has obtained limited assurance that no material modifications to the financial statements are necessary in order for them to be in conformity with the applicable financial reporting framework.

The question of how much evidence is enough is subject to a high degree of professional judgment. Some indicators that the accountant did not have sufficient review evidence are:

- A representation letter dated after the report date
- Responses to the accountant’s inquiries about significant matters that are dated after the report date
- Material adjusting entries made after the report date
- Other significant review procedures that are performed after the report date

This problem often arises from the discovery of a material adjusting entry late in the engagement. Frequently this happens during the review of the draft financial statements, when either the accountant or the client spots “just one more thing” that requires an adjustment.

Another prevalent cause is a simple lack of attention to the dating of the report compared to the engagement’s timeline, and the dates on which key review evidence was obtained. This may occur due to deadline pressures, or to simple lack of awareness of the requirements.

Solutions. The best solution to this problem is usually attention to detail in the preissuance review process. Most particularly, the report and the representation letter should bear the same date. Those dates should not be earlier than the dates on which all significant adjusting entries were discovered and all significant inquiries and other review procedures were completed.

Simple inattention to detail is best corrected, as a first-level measure, by instilling professional discipline through training and setting a positive “tone at the top” within the firm, which emphasizes quality of performance, and by training to heighten engagement personnel’s awareness of the importance of report dating.
STUDY QUESTION

1. All of the following are responsibilities of management that should be addressed in the accountant’s compilation report except:

   a. The fair presentation of the financial statements in accordance with the applicable financial reporting framework
   b. Designing internal controls relevant to the preparation and fair presentation of the financial statements
   c. Conducting the engagement in accordance with SSARS
   d. The preparation of the financial statements in accordance with the applicable financial reporting framework

PERFORMANCE

Issue No. 3: Failure to Obtain a Written Understanding with the Client

Problem. Some firms, particularly those with long-established, high-volume monthly compilation practices, have not traditionally obtained written understandings with their clients for their compilation services. SSARS 19 says that the accountant should:

- Establish an understanding with management regarding the services to be rendered in a compilation or review engagement
- Document the understanding through a written communication with management, in the form of an engagement letter

Failure to have a written understanding is now considered a significant deficiency by the AICPA Peer Review Program, and would cause a firm not to pass its engagement review.

This is sometimes caused by resistance on the part of long-standing clients to sign an engagement letter in a situation where none had been required before. It may also be caused by simple habit, or expediency on the firm’s part.

Solution. Firms should, first of all, read and understand the complete text of SSARS 19 as it applies to their practices. These requirements, in particular, should be emphasized in staff training. This pronouncement contains illustrative engagement letters for both compilation and review engagements. Firms should then make sure that all compilation and review clients have appropriate engagement letters. On a firm-wide level, monitoring procedures should target this matter.
Issue No. 4: Failure to Obtain a Representation Letter in a Review

Problem. The requirement to obtain a representation letter in a review engagement is not new with SSARS 19. Some firms, however, are still not in compliance. This can arise from a number of causes, including:

- Simple lack of awareness of the requirement. This most often happens in a firm that does only one, or a very few, reviews.
- Intentional omission. This most frequently occurs in very small engagements with limited time budgets, in an effort to cut corners and increase hourly fee realization.
- Negligent omission. This sometimes happens when under deadline pressure to issue the review report.
- Comparative financial statements. The representation letter for the current year should cover all financial statement periods presented. When the representation letter covers only the current period, the cause has most likely been either lack of awareness or misunderstanding of the requirement, or negligence in the selection of the representation letter template from the firm’s practice aids. This problem is covered in detail in Issue No. 7: Representation Letter Does Not Cover All Financial Statement Periods, below.

Solutions. Firms should give thought to the cause of any failure to obtain a representation letter. This should include asking engagement personnel about their views as to the cause of the failure, and examining the design and implementation of the firm’s system of quality control elements that address representation letters.

- In the case of simple lack of awareness, the most direct solution is to read and understand the requirements. The firm should also consider whether its practice aids contain appropriate templates for representation letters, and whether those practice aids are accessible to engagement personnel.
- Intentional omissions are best corrected, as a first-level measure, by instilling professional discipline through training and setting a positive “tone at the top” within the firm, which holds that quality of performance is not to be compromised for commercial considerations such as fee realization. A strong pre-issuance review program, which includes a step for assuring that representations have been obtained, is a secondary control measure for this problem.
- Negligent omissions are more difficult to address because their causes may be more varied. These are usually best remedied by training to heighten engagement personnel’s awareness of the importance of obtaining representations, along with specifically targeted pre-issuance review procedures.
STUDY QUESTION

2. SSARS 19 requires accountants to:
   a. Establish an understanding with those charged with governance regarding the services to be rendered in a review engagement
   b. Establish an understanding either orally or in writing with management regarding the services to be rendered in a compilation engagement
   c. Establish a written understanding with management only for new compilation or review clients accepted after the effective date of SSARS 19
   d. Establish and document an understanding with management regarding the services to be rendered in a compilation or review engagement

DOCUMENTATION

Issue No. 5: Obtaining an Incomplete Understanding with the Client

Problem. SSARS 19 introduced some new elements into the required understandings that accountants should obtain with their compilation and review clients. Firms sometimes have engagement letters that do not cover all of the required elements. This is a variety of, but less serious than, Issue No. 3: Failure to Obtain a Written Understanding with the Client, above.

Consistent with the AICPA’s philosophical aim to draw a clear distinction between the responsibilities of management and those of the accountant, SSARS 19 has created some specific new elements of the understanding for compilation and review engagements. Engagement letters for both compilations and reviews should list the following as responsibilities of management:

- The preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework
- Designing, implementing, and maintaining internal controls relevant to the preparation and fair presentation of the financial statements
- Preventing and detecting fraud
- Identifying and ensuring compliance with laws and regulations applicable to the entity’s activities
- Making all financial records and related information available to the accountant

Engagement letters for reviews should also state that management is responsible for providing the accountant, at the conclusion of the engagement, with a letter that confirms certain representations made during the review.

Failure to include all of the required elements can usually be traced to:

- Lack of awareness of the new requirements
- Failure to update old engagement letter templates
**Solutions.** As with Issue No. 3: Failure to Obtain a Written Understanding with the Client, above, action items to solve this problem may include:

- Reading the requirements of SSARS 19 for obtaining an understanding with the client, including the illustrative engagement letters
- Comparing the wording with their existing engagement letter templates, and make updates as needed
- Specifically targeting this matter in the preissuance review process at the engagement level
- Specifically targeting this matter in monitoring procedures at the firm-wide level

**Issue No. 6: Improperly Dated Representation Letters**

**Problem.** SSARS 19 requires that the representation letter be dated as of the date of the accountant’s review report. Departures from this requirement can be caused by:

- Lack of awareness of the requirement
- Lack of attention to dating
- Significant last-minute changes to the draft financial statements, which cause the date that the review procedures were completed to change
- Deadline pressure to issue the report, such that it gets dated before the representation letter
- Delays in issuing the report, such that it gets dated later than the representation letter

These problems can be closely allied with those in Issue No. 2: Improper Dating of Review Reports, above.

**Solutions.** This problem is usually best solved by training. This may be as simple as reading SSARS 19 to develop awareness of its requirements. In the case of inattention to dating, this training might include instilling professional discipline through setting a positive “tone at the top” within the firm, which emphasizes quality of performance, and heightening engagement personnel’s awareness of the importance of representation letter dating.

Since the representation letter is created at the end of the engagement, circumstances that disrupt the end-process, such as significant last-minute changes, deadlines, or delays, should always cause caution.

In some circumstances, such as when there is a significant delay between the date of the accountant’s report and its issuance, the accountant should consider obtaining an updating representation letter. This letter should state whether information has come to management’s attention that would cause them to believe that its previous representations should be modified, and whether any subsequent events have occurred that would require adjustment to or disclosure in the financial statements.
Additional action items to solve this problem may include:
- Preissuance review procedures targeting the dating of the representation letter, especially when the end-process of the engagement has been disrupted by deadline pressure or delay.
- Monitoring procedures at the firm-wide level targeting the dating of the representation letter.

Issue No. 7: Representation Letter Does Not Cover All Financial Statement Periods

**Problem.** The representation letter for the current period’s review engagement should cover all financial statement periods presented. This is not a new requirement with SSARS 19, yet it continues to be problematic for some practitioners. The AICPA Peer Review Program regards this as a significant deficiency that, for a firm with only a compilation and review practice, would cause it not to pass its peer review. One of the rationalizations for this omission is that “we have a representation letter from last year that covers the prior period.” This rationalization does not work because those representations are a year old, and management’s representations about the earlier period’s statements could have changed in that time.

This problem usually arises from:
- Lack of awareness of the requirement
- Failure to update old representation letter templates
- Recent change from single-year to comparative presentation

**Solutions.** This problem is usually best solved by training. This may be as simple as reading SSARS 19 to develop awareness of its requirements. When a failure to update old templates for the representation letter has resulted from inattention rather than lack of awareness, training might include instilling professional discipline through setting a positive “tone at the top” within the firm, which emphasizes quality of performance, and heightening engagement personnel’s awareness of this requirement.

Additional action items to solve this problem may include:
- Preissuance review procedures at the engagement level targeted toward this problem
- Monitoring procedures at the firm-wide level that periodically evaluate whether engagement correspondence as a whole, including representation letters, conforms with current standards.

Issue No. 8: Representation Letter Omits Required Elements

**Problem.** SSARS 19 contains some requirements for expanded representations covering management’s responsibilities that some firms have not incorporated into their current representations letters. At a minimum, those representations should address:
Management’s acknowledgement of its responsibility for the financial statements
Management’s belief that the financial statements are fairly presented
Management’s acknowledgement of its responsibility for internal control
Management’s acknowledgement of its responsibility to prevent and detect fraud
Management’s knowledge of any material fraud or suspected fraud
Management’s full and truthful response to all inquiries
The completeness of information
Subsequent events

This problem usually arises from:
- Lack of awareness of the requirement
- Failure to update old representation letter templates

**Solutions.** As with Issues No. 6 and 7 above, this problem is often best resolved by training.

Additional action items to solve this problem may include:
- Preissuance review procedures at the engagement level targeted toward completeness of management representations
- Monitoring procedures at the firm-wide level that periodically evaluate whether engagement correspondence as a whole, including representation letters, conforms with current standards

**Issue No. 9: Poorly Designed or Documented Analytical Procedures**

**Problem.** The requirements for analytical procedures in a review engagement are not new. Yet, some firms continue to use poorly designed procedures that may not achieve engagement objectives, or to produce inadequate documentation.

SSARS 19 allows the accountant considerable professional judgment as to the exact nature and extent of analytical procedures. They may, for example, be performed at the financial statement level or at the detailed account level. SSARS 19 requires that accountants investigate, by inquiry and other procedures as necessary in the circumstances, when analytical procedures identify fluctuations or relationships that differ significantly from expected values. There is no requirement to corroborate management’s responses with other evidence. However, the accountant may need to perform other procedures when management is unable to provide an explanation or when that explanation appears inadequate.

Software packages have enabled accountants to generate trend analyses, ratio analyses, charts, and graphs that can be useful tools in applying analytical procedures. In many cases, however, these computer-generated materials appear in the review documentation with little or no evidence that they have been read or considered by engagement personnel. A multiyear comparative
income statement analysis, showing dollar and percentage variances, for example, is a starting point, not an ending point in performing analytical procedures. Properly documented analytical procedures usually contain:

- Documentation of the accountant’s expectations for the comparison
- Comments on significant variances from those expectations
- Follow-up procedures on the variances, usually in the form of inquiries of management

Software packages and published practice aids for review engagements invariably contain comprehensive templates for ratio analyses. In some cases, these templates are completed in a mechanical fashion, without consideration to whether particular ratios are useful or relevant in the circumstances. This approach wastes the accountant’s time and diverts attention from potentially important issues.

In other cases, familiarity with a client may cause engagement personnel to consider that the expectations in a particular analytical procedure are obvious, when they are not. Trend analyses, for example, usually carry with them an implicit expectation of consistency over time. In a turbulent economy, however, this expectation may not be valid. Client familiarity may also lead to a lack of documentation for the reasons why significant variances appear, or to poorly documented follow-up procedures. SSARS 19 requires that management’s responses to inquiries about relationships or fluctuations that are inconsistent with expectations or other relevant information be documented.

Experienced accountants may also be in the habit of performing valid analytical procedures in an intuitive fashion, and not documenting them well. This often happens when an accountant finds that something in the financial statements “just doesn’t look right,” and takes some action to “fix it.”

**Solutions.** Accountants may find it helpful to ask themselves two questions about their use of analytical procedures. These questions can be useful as pre-issuance review tools, in assessing the results of an engagement. It is also efficient to ask them prospectively, in the planning of the analytical procedures.

- **Have I actually done the work, and is it relevant and useful under the circumstances?** This question asks whether appropriate procedures were actually performed, and whether those procedures went beyond the perfunctory completion of a worksheet out of a set of practice aids.

- **Does the documentation clearly show a path to relevant conclusions?** This question asks whether the documentation demonstrates what the accountant thought and did as a result of the particular procedures, such as:
  - Reaching a conclusion that the subject data was reasonable compared to expectations
- Questioning whether the subject data was reasonable or concluding that it was unreasonable
- Performing additional procedures such as inquiries to determine the reasons for variances from expectations
- Proposing adjustments to management to correct misstatements detected as a result of the analytical procedures

The answers to these questions will usually lead to improved analytical procedures in the form of procedures that:
- Are more relevant and useful to the engagement
- Are more clearly and completely documented
- Lead to relevant conclusions

Additional action items to solve this problem may include:
- Staff training to enhance the awareness of need for well-designed and documented analytical procedures, including methods of documentation
- Preissuance review procedures targeted toward the design and documentation of analytical procedures at the engagement level
- Monitoring procedures targeted toward the design and documentation of analytical procedures at the firm-wide level

**Issue No. 10: References to Outdated Standards**

**Problem.** The documentation for some compilation and review engagements contains references to outdated Financial Accounting Standards Board (FASB) Standards. The old FASB standards, which were usually cited, for example, as FASB 109 or SFAS 109, have been superseded by the new Accounting Standards Codification (ASC). References to the old standards continue to appear in the representation letters for review engagements, the engagement letters for compilation and review engagements, and in the notes to some financial statements. This is frequently caused by:
- Lack of awareness of the change to the new FASB Accounting Standards Codification
- Failure to update old templates

**Solutions.** The new ASC contains a cross-reference between the old FASB or SFAS citations and the new ASC citations. However, before culling through every set of financial statement disclosures, and every representation letter or other piece of engagement correspondence, accountants may wish to challenge the usefulness of the practice of citing specific pronouncements in every case.
Increasingly accepted practice in the preparation of notes to financial statements is to move away from citing specific pronouncements, for example, ASC 855, in favor of simply referring to generally accepted accounting principles.

Action items to solve this problem may include:

- A comprehensive update of the firm’s documentation templates for its compilation and review engagements that includes scanning for outdated FASB references
- Emphasizing this matter in staff training
- Targeting the referencing of FASB standards in preissuance review of engagements
- Targeting the referencing of FASB standards in monitoring procedures at the firm-wide level

**STUDY QUESTION**

3. Management’s representations in a review engagements should at a minimum address which of the following?

   a. Management’s full and truthful response to all inquiries
   b. The completeness of the corporate minutes, if applicable
   c. The details of all consultations with legal counsel
   d. Management’s reliance on the accountant for the completeness of financial statement disclosures
MODULE 2: IMPLEMENTATION ISSUES — CHAPTER 5

Principles Underlying an Audit

LEARNING OBJECTIVES

Upon completion of this chapter, the reader should be able to:

- Explain the purpose of an audit
- Describe the premises on which an audit is conducted
- Distinguish between the responsibilities of the entity’s management and those of the auditor in conducting an audit
- Explain the concept of reasonable assurance

INTRODUCTION

The AICPA’s new Codification of Statements on Auditing Standards contains a two-page preface entitled Principles Underlying an Audit Conducted in Accordance With Generally Accepted Auditing Standards. This preface is important because it sets forth broad philosophical principles underlying an audit conducted in accordance with generally accepted auditing standards (GAAS).

These principles provide a framework that is useful in understanding and explaining an audit. They are organized to provide a structure for the new codification of auditing standards. This structure addresses:

- The purpose of an audit
- The personal responsibilities of the auditor
- Auditor actions in performing the audit
- Reporting

The principles are not requirements. They do not carry any authority.

STUDY QUESTION

1. The preface to the new Codification of Statements on Auditing Standards provides a structure for the new codification of auditing standards which addresses all of the following except:
   a. The auditor’s responsibilities in conducting an audit
   b. Independence, integrity, and objectivity in conducting an audit
   c. Reporting on an audit
   d. The purpose of an audit
PURPOSE OF AN AUDIT AND PREMISE UPON WHICH AN AUDIT IS CONDUCTED

Purpose of an Audit
The purpose of an audit is to provide users of the financial statements with an opinion by the auditor on whether the financial statements are fairly presented, in all material respects, in accordance with the applicable financial reporting framework. This opinion enhances the degree of confidence that intended users can place in the financial statements.

OBSERVATION
As with existing standards, the phrase “in all material respects” is a key concept. It emphasizes to financial statement users that an audit does not concern itself with matters that are not important to the financial statements taken as a whole.

The term “applicable financial reporting framework” is a new term within the revised standards. It replaces the familiar term “basis of accounting.”

Premise upon Which an Audit Is Conducted
An audit in accordance with GAAS is conducted on the premise that management and, where appropriate, those charged with governance have specific responsibilities.

Preparation and fair presentation. Management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework. This includes the design, implementation, and maintenance of internal controls pertaining to the preparation and fair presentation of financial statements that are free from material misstatement, whether caused by fraud or error.

Auditor access to information. Management is responsible for providing the auditor with the information needed to conduct the audit. This includes:

- All information such as records, documentation, and other matters relevant to the preparation and fair presentation of the financial statements
- Any additional information that the auditor may request from management or those charged with governance
- Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence
OBSERVATION

This section is consistent with a major philosophical direction taken by the AICPA standard setters in recent years to draw a bright line between management’s responsibilities and those of the auditor. Management is clearly tasked with statement preparation and internal control, and is expected to cooperate with the auditor in providing any information that in the auditor’s professional judgment is necessary.

STUDY QUESTION

2. Which of the following statements best applies to the premise upon which an audit is conducted?
   
a. The auditor is responsible for the fair presentation of the financial statements.
b. The auditor is responsible for the design of internal controls.
c. Management is responsible for providing the auditor with access to persons within the entity from whom it determines that it is appropriate to obtain audit evidence.
d. Management is responsible for providing the auditor with the information, such as records and documentation, needed to conduct the audit.

RESPONSIBILITIES

The auditor’s responsibilities are to:
- Have appropriate competence and capabilities to perform the audit
- Comply with relevant ethical requirements
- Maintain professional skepticism throughout the planning and performance of the audit
- Exercise professional judgment throughout the planning and performance of the audit

PERFORMANCE

In order to express an opinion on the financial statements as a whole, the auditor obtains reasonable assurance about whether they are free from material misstatement, whether caused by error or by fraud.

Reasonable assurance is a high, but not absolute, level of assurance. To obtain reasonable assurance, the auditor:
- Plans the audit
- Properly supervises any assistants
- Determines and applies appropriate materiality level or levels throughout the audit
- Identifies and assesses risks of material misstatement, due to either error
or fraud, based on an understanding of the entity and its environment, including its internal control. Obtains sufficient appropriate audit evidence about whether material misstatements exist by designing and implementing appropriate responses to assessed risks.

The auditor is not able to obtain absolute assurance, due to inherent limitations that arise from:
- The nature of financial reporting
- The nature of audit procedures
- The need for the audit to:
  - Be conducted within a reasonable time period
  - Achieve a balance between cost and benefit

**OBSERVATION**

This section is an attempt to close the “expectations gap” in auditing, in which the public perceives that auditors test every transaction and root out every error no matter how small. The concepts of reasonable but not absolute assurance, materiality, and the inherent limitations of the process, especially the cost-benefit considerations, are set forth here in succinct form as the profession’s effort to educate the public about the real-world constraints on the audit process.

**STUDY QUESTION**

3. Which of the following statements best applies to the premise of reasonable assurance?

   a. Reasonable assurance is a moderate level of assurance.
   b. Reasonable assurance does not include the assurance that the financial statements are free from material misstatement due to fraud.
   c. Reasonable assurance involves obtaining sufficient appropriate audit evidence about whether material misstatements exist.
   d. Reasonable assurance is not attainable due to the inherent limitations of audit procedures.

**REPORTING**

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

Upon completion of this chapter, the reader should be able to:

- Define the levels of accounting guidance as determined by the Financial Accounting Standards Board (FASB)
- Explain the practitioner’s responsibilities for applying guidance contained in the various levels of auditing, attestation, and compilation and review literature
- Distinguish the authoritative levels of auditing, attestation, and compilation and review publications

INTRODUCTION

Recent years have brought a comprehensive redrafting of professional standards governing accounting, auditing, attestation, and compilation and review practice. A common thread running through these redrafting projects has been to simplify the standards and to move from a strictly rules-based platform to a more principles-based environment. As a result, the old hierarchies governing the authoritative status of the professional literature have been reorganized. This course summarizes the authoritative levels contained in each of these bodies of redrafted professional literature.

ACCOUNTING STANDARDS

With the issuance of the new Accounting Standards Codification (the Codification, cited as “ASC”), the hierarchy of generally accepted accounting principles (GAAP) was reduced from four levels to two levels.

Authoritative Guidance

The FASB Accounting Standards Codification is the sole source of authoritative GAAP for nonpublic nongovernmental entities in the United States. For public entities, the rules and interpretive releases of the Securities and Exchange Commission (SEC) are also sources of authoritative GAAP. The Codification does not affect or replace guidance issued by the SEC or its staff for SEC registrants in their filings with the SEC.

When guidance for an event or transaction is not specified in a source of authoritative GAAP, the entity should:

- First consider accounting principles for similar events or transactions in sources of authoritative GAAP, except when those principles either:
Prohibit their application to a particular event or transaction, or
State that the accounting treatment should not be applied by analogy.
Consider second the guidance from nonauthoritative sources.

Nonauthoritative Guidance
Any accounting or financial reporting practices not included in the Codification are nonauthoritative. The Codification lists the following as examples of nonauthoritative guidance and literature:

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

The appropriateness of nonauthoritative sources depends on:
- Their relevance to particular circumstances
- The specificity of their guidance
- The general recognition of the issuer or author as an authority
- The extent of their use in practice

Certain accounting standards have permitted the continued application of superseded standards for transactions that have an ongoing effect on an entity’s financial statements. These superseded standards have not been included in the Codification but are considered grandfathered, and continue to be authoritative. Examples of such standards are listed in the ASC and include, among others:

- Pooling of interest in a business combination
- Loans restructured in a troubled debt restructuring
- Stock compensation for nonpublic entities

STUDY QUESTION

1. Which of the following publications is considered to be the authoritative source of GAAP for nonpublic nongovernmental entities in the United States?
   a. FASB Concepts Statements
   b. AICPA Issues Papers
   c. The FASB Accounting Standards Codification
   d. AICPA Statements on Standards for Accounting and Review Services
AICPA PROFESSIONAL STANDARDS

The AICPA Professional Standards cover auditing, attestation, and compilation and review engagements. Each contains a three-level hierarchy:

- **Standards.** Practitioners are required by Rule 202, *Compliance With Standards*, of the AICPA *Code of Professional Conduct* to comply with the Standards.

- **Interpretive publications.** Practitioners are expected to be familiar with these publications and to consider their guidance in planning and performing applicable engagements. They should be prepared to explain how they fulfilled the requirements of the Standards when they have not applied the guidance in these publications.

- **Other publications.** These publications have no authoritative status, but they may help practitioners understand and apply the Standards. Practitioners are not expected to be aware of the entire body of this literature. Practitioners should assess the relevance and appropriateness of guidance contained in other publications, using professional judgment, in applying it under the circumstances of an engagement. They may presume that other publications published by the AICPA that have been reviewed by its Audit and Attest Standards staff are appropriate. In determining the appropriateness of a publication that has not been reviewed by the AICPA Audit and Attest Standards staff, practitioners may wish to consider the degree to which:
  - It is recognized as being helpful in understanding and applying the Standards.
  - The author or issuer is recognized as an authority on subject matter.

STUDY QUESTION

2. Which of the following statements best applies to the hierarchy of the AICPA standards for auditing, attestation, and compilation and review engagements?

   a. Practitioners are expected to be aware of all of the “other publications” that are applicable to their auditing, attestation, and compilation and review engagements.

   b. Practitioners are expected to be familiar with the “interpretive publications” applicable to their engagements, and to consider their guidance in planning and performing those engagements.

   c. “Other publications” have authoritative status above that of “interpretive publications.”

   d. The “condition” element of a finding provides a context for evaluating evidence and understanding findings.

Auditing Standards

**Standards.** The AICPA’s Clarity Project revised and recodified the existing body of auditing standards. This body of literature, entitled *Codification of*
Statements on Auditing Standards (Clariﬁed) and also commonly referred to as the “AU-C Sections,” became effective for audits of ﬁnancial statement periods ending on or after December 15, 2012. It constitutes the entire body of authoritative literature for audits of nonpublic entities.

Interpretive publications. Interpretive publications include:

- Auditing interpretations of GAAS
- Exhibits to GAAS
- Auditing guidance contained in AICPA Audit and Accounting Guides
- AICPA Auditing Statements of Position (SOP) in Technical Practice Aids

These publications are not auditing standards. They are recommendations on the application of GAAS in speciﬁc circumstances and for specialized industries. An interpretive publication is issued under the authority of the Auditing Standards Board (ASB), after consideration of whether it is consistent with GAAS.

Auditing interpretations of GAAS are included in the respective AU-C sections in Volume I of the AICPA’s Professional Standards.

Audit and Accounting Guides and SOPs are listed in AU appendix D of Volume I of Professional Standards.

Other auditing publications. Other auditing publications include:

- AICPA publications not deﬁned as interpretive publications, including:
  - AICPA Alerts
  - AICPA Audit and Accounting Manual
  - Speciﬁc sections of AICPA Technical Practice Aids, including Technical Questions and Answers
  - Checklists and Illustrative Financial Statements
  - Practice Aids
  - White papers
  - Auditing articles in the Journal of Accountancy and other professional journals
  - Auditing articles in the AICPA’s CPA Letter
- Continuing professional education programs
- Other instructional materials
- Textbooks
- Guidebooks
- Audit programs and checklists
- Other auditing publications from:
  - State CPA societies
  - Other organizations
  - Individuals
Auditors may presume that other auditing publications published by the AICPA that have been reviewed by its Audit and Attest Standards staff are appropriate. These publications are listed in AU appendix F of Volume I of Professional Standards.

**Attestation Standards**

**Standards.** The ASB’s *Statements on Standards for Attestation Engagements* (SSAEs) constitute the authoritative literature for attestation engagements. They are also referred to as the “AT sections.”

**Attestation interpretations.** Attestation interpretations include:
- Attestation Interpretations included in AT sections 9000 of *Professional Standards*
- Appendices to the SSAEs
- Attestation guidance included in AICPA Audit and Accounting Guides
- Attestation SOPs contained in Technical Practice Aids

**Other attestation publications.** These publications include:
- AICPA publications not defined as interpretive publications, including:
  - AICPA Alerts
  - AICPA Audit and Accounting Manual
  - Specific sections of AICPA Technical Practice Aids, including Technical Questions and Answers
  - Checklists and Illustrative Financial Statements
  - Practice Aids
  - White papers
  - Attestation articles in the *Journal of Accountancy* and other professional journals
  - Attestation articles in the AICPA’s *CPA Letter*
- Continuing professional education programs
- Other instructional materials
- Textbooks
- Guidebooks
- Attest programs and checklists
- Other attestation publications from:
  - State CPA societies
  - Other organizations
  - Individuals

**Compilation and Review Standards**

**Standards.** The AICPA’s Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services No. 19 (SSARS 19), *Compilation and Review Engagements*, with an effective
date for financial statement periods ended on or after December 15, 2010. This pronouncement superseded all previous SSARS. It is the sole source of authoritative guidance on compilation and review services. It is also referred to in the literature as the “AR sections.”

**Interpretive publications.** Interpretive publications include:

- Compilation and review interpretations of SSARS
- Appendixes to SSARS
- Compilation and review guidance included in AICPA Audit and Accounting Guides
- AICPA Statements of Position, to the extent that they are applicable to compilation and review engagements

These publications are not standards for accounting and review services. They are recommendations on the application of SSARS in specific circumstances and for specialized industries. An interpretive publication is issued under the authority of the ARSC, after consideration of whether it is consistent with SSARS.

**Other compilation and review publications.** These publications include:

- AICPA publications not defined as interpretive publications, including:
  - The annual AICPA Compilation and Review Alert
  - Compilation and review articles in the Journal of Accountancy and other professional journals
  - Compilation and review articles in the AICPA’s CPA Letter
  - AICPA Audit and Accounting Manual
  - Specific sections of AICPA Technical Practice Aids, including Technical Questions and Answers
  - Checklists and Illustrative Financial Statements
  - Practice Aids
  - White papers
- Continuing professional education programs
- Other instructional materials
- Textbooks
- Guidebooks
- Compilation and review programs and checklists
- Other compilation and review publications from:
  - State CPA societies
  - Other organizations
  - Individuals
### STUDY QUESTION

3. Which of the following is considered to be an “interpretive publication” for purposes of applying SSARS?

- a. A compilation and review article in the *Journal of Accountancy*
- b. The annual AICPA *Compilation and Review Alert*
- c. Statement on Standards for Accounting and Review Services No. 19
- d. Compilation and review guidance included in AICPA Audit and Accounting Guides
CURRENT IMPLEMENTATION ISSUES — CHAPTER 7

Current Implementation Issues for Auditing Standards

LEARNING OBJECTIVES

Upon completion of this chapter, the reader should be able to:

- Recognize current auditing standards implementation issues facing the profession
- Describe the effects on auditing practice of certain recent changes in professional standards
- Explain the causes of certain auditing standards implementation problems
- Explain possible solution approaches to these implementation problems

INTRODUCTION

The current onslaught of changes in auditing standards, both as a direct result of the AICPA Clarity Project and stemming from other changes to long-established practices, has raised many implementation issues for the performance and documentation of audits.

This course discusses some of the most prevalent issues that audit practitioners are facing in the implementation of these standards, and suggests some possible approaches to resolving them. Those issues include:

- Risk assessment
- Internal control
- Auditor communications
- Reporting
- Opening balances
- Quality control

This course is not a statistical or scientific study or inquiry into the nature or frequency of audit standards implementation problems. Rather, it was conceived out of a series of conversations, formal and informal, between audit practitioners throughout the nation, from the largest to the smallest firms, that took place at the 2012 AICPA Peer Review Conference. Some of these issues are likely to arise from implementation of the AICPA’s new Codification of Statements on Auditing Standards (Clarified), while other issues linger from the many sweeping changes to the standards that have been made in recent years.
RISK ASSESSMENT

The risk assessment standards have existed for some time. However, there are still implementation issues in more than a small percentage of audit practices. These are significant problems because risk assessment has far-reaching effects on the design of further audit procedures, and thus on the performance of many other areas of the audit.

Correlation of Risk Assessment to the Design of Further Audit Procedures

One of the core premises of the whole suite of risk assessment standards is that auditors should concentrate their audit resources on the areas where the risk of material misstatement is the highest. These standards are meant to be applied on three levels:

- The financial statements as a whole
- Account balances and transactions
- Relevant assertions

Most auditors do well in assessing risks at the financial statement and account balance/transaction class levels. But they sometimes do not assess risks at the “relevant assertion” level, or may do so intuitively but not document the assessment. This often stems from a poor understanding of the standards, and the relationship that they intend to make between the assessed risk of material misstatement and the design of further audit procedures.

One of the consequences of this poor understanding is that further audit procedures may not respond efficiently, or even adequately, to assessed risks of misstatement. This can happen when third-party practice aids are used in a mechanical fashion. For example:

- Risk assessment practice aids are filled out, but their results are not considered in applying further audit procedures.
- Third-party audit programs are completed in a mechanical fashion without correlating the nature and scope of further audit procedures to the risk assessment.
- Third-party audit programs are not appropriately tailored to the engagement’s needs, and thus unnecessary work is performed.

The Public Company Accounting Oversight Board (PCAOB) has often cited auditors of SEC-issuers for poorly correlating the nature and extent of their audit procedures with their risk assessment. This led them to over-audit areas of low risk, and under-audit higher risk areas.
EXAMPLE

Accounts payable. Completeness is one of the relevant assertions that auditors normally regard as important for accounts payable. An extensive search for unrecorded liabilities through inspection of subsequent disbursements usually implies that the auditor assessed the risk of material misstatement due to incompleteness to be high. In this case, the risk of material misstatement for the completeness assertion would be expected to be assessed at a relatively high level, and to be documented accordingly. If the risk assessment in the audit documentation is indicated to be at a low level in this situation, it is not congruent with the scope of the unrecorded liabilities test work. This suggests that either risk is incorrectly assessed as too low or scope of the test work is too large, and thus is inefficient.

Prepaid expenses. An example to the contrary involves extensive substantive tests of details for prepaid expenses. Prepaid expenses are often immaterial. They can usually be efficiently and effectively tested by substantive analytical procedures, such as by comparison to prior years’ balances and the related expense accounts. Sometimes, however, even though the risk of material misstatement is assessed as low, the audit programs are not thoughtfully tailored to reflect this. As a result, inexperienced staff may apply extensive vouching procedures to disbursements and perform recalculations of amortization when the risk assessment does not justify this level of effort. This is at best an inefficient practice with respect to the prepaid balances and may lead to ineffective auditing in higher risk areas if it diverts audit resources away from them.

Revenue recognition. Revenue recognition, and particularly the cutoff assertion for revenue, is traditionally considered a high-risk area. The risk assessment practice aids may indicate a high level of assessed risk. Yet, testing of revenues may be limited only to substantive analytical procedures. This may represent under-auditing of a high risk area.

Documentation of Risk Assessment

Under existing standards, audit work that is not documented is presumed not to have been done. The outright failure to document any risk assessment is fairly rare and is usually attributable to ignorance of the standards, or negligence. However, in many instances well-intentioned firms either:

- Poorly document a risk assessment that they actually performed, or
- Are poorly served by the form of risk assessment documentation that they create.

The discussion that follows treats the common documentation methods for risk assessment and their implications for the conduct of the audit.

Documentation approaches. The standards do not specify how risk assessments are to be documented. This leads to a wide diversity of acceptable practices. Firms often use either structured questionnaire or fill-in-the-blank—type documents that are most frequently kept in a centralized location within the audit file, or narrative memoranda that are sometimes in a centralized location and sometimes dispersed throughout the specific accounts workpapers.
to which they relate. Depending on the firm’s practice, the nature of the clients, and the preference of individual auditors, either approach can work. The downside of having all the risk assessment documentation in a central location is that it may, absent proper supervision, become “out-of-sight, out-of-mind” to staff when they are performing further audit procedures in specific accounts areas. Conversely, when risk assessments for each area of the audit are dispersed throughout the audit file, it may be easy to lose the “big picture” view of audit risk.

The structured-document approach is often efficient in the sense that when the document is thoughtfully completed, it gives a fairly high assurance that relevant areas have been considered. The downsides of the structured-document approach are that:

- It may encourage auditors to think within a box that may be either too large or too small for the circumstances of particular engagements. This approach can, however, be a useful training vehicle for lesser-experienced staff because it guides their considerations of risk in structured channels. It should be emphasized to those staff, however, that it may also be necessary to look outside of those channels.
- Because of the deliberately comprehensive nature of most published practice aids, they may contain large amounts of irrelevant material that will take significant time to cull.
- When used unthoughtfully or by inexperienced persons, it may lead to a mechanistic approach in which boxes are checked off with inadequate consideration.

Narrative memoranda, on the other hand, may require more experience to complete effectively, because of their inherently open-ended and free-form nature. Inexperienced staff may easily overlook crucial considerations. However, these memoranda are beneficial because they may allow attention to focus on significant risks that are outside of the structures in which auditors are trained to assess risks.

**Documentation deficiencies.** Risk assessment documentation, especially in smaller audits, sometimes tends to be “inferential” or to “work backwards” from the audit test work to a risk assessment. In other words, by looking at the nature and extent of the further audit procedures, one can infer, or “work back to,” what the auditor thought the risk to be. The more intensive the audit procedures, the higher the assessed risk must have been, so this reasoning goes. When the scope of the audit work performed is congruent with the actual risks, this approach is neither inefficient nor strictly speaking ineffective, to the extent that it leads to obtaining sufficient appropriate evidence to support an opinion. One problem with this approach is that it tends to leave the documentation of the risk assessment at an implicit level. This reduces the supervisory control over the correlation of risk assessment
to the nature and extent of the further audit procedures. It would be difficult to tell if the actual audit procedures were either too extensive, or not extensive enough for the true assessed level of risk. This creates the danger that high-risk areas can be glossed over without adequate testing.

Possible Solutions

The systemic solution to any of these issues is usually to gain a better understanding of the objectives of the standards, and to apply them thoughtfully in performing the audit.

In order to stimulate a thoughtful approach to risk assessment, consider performing a mental exercise as a part of the “brainstorming” session among the audit team during the planning phase of the engagement. In that exercise, the auditor is allowed as much time as would be normal to plan the audit and to conclude it. But the field work time allowed is set at an artificial and extremely low level, such as one hour for a small audit or one day for a large audit. Ask two questions:

- What is the one area that creates the most concern?
- What audit procedures should be done in the short time allowed to address that area?

These questions will usually focus attention on the highest risk area and on the essential procedures for addressing it. Once those questions are answered, suppose that the audit is allowed one more hour, or one more day. What is the next biggest area of concern? Repeat this cycle a few more times. This will often provide a good basic roadmap for the audit. Then, flesh out the audit plan based on the standard time that would normally be budgeted.

STUDY QUESTION

1. A poor correlation of the assessed risk of material misstatement to the design of further audit procedures may be indicated in all of the following circumstances except:

   a. The risk of material misstatement of revenue due to cutoff errors is assessed as high, and testing of revenues is limited to substantive analytical procedures.
   b. The risk of material misstatement of immaterial recorded accrued expenses due to incompleteness is assessed as low, and testing of accrued expenses is limited to substantive analytical procedures.
   c. The risk of material misstatement of accounts payable due to incompleteness is assessed as low, and an extensive search for unrecorded liabilities through inspection of subsequent disbursements is performed.
   d. The risk of material misstatement of occupancy expenses due to incorrect cutoff is assessed at low, and substantive tests of details include extensive vouching to vendors’ invoices.
INTERNAL CONTROL

The standards for internal control have likewise been effective for some time now. Implementation of these standards is closely related to both risk assessment and to auditor communications and, like risk assessment, has pervasive effects on the audit as whole.

Documenting Consideration of Significant Deficiencies and Material Weaknesses

It is important for auditors to document consideration of deficiencies in internal control and to evaluate whether they are significant deficiencies or material weaknesses. One of the reasons why this is important is the requirement to communicate significant deficiencies and material weaknesses to management in writing, as discussed under Auditor Communications, below.

When an auditor proposes a material adjustment to the financial statements, this ordinarily raises the question of whether it represents a significant deficiency or material weakness. Audit documentation sometimes evidences material adjusting entries that would ordinarily be considered indicators of at least significant deficiencies, yet there is no communication of the matters in the management letter. This raises doubt as to whether the auditor evaluated its internal control implications.

There can be many reasons why a material audit adjustment might not represent a control deficiency. These often occur in audits of small entities.

EXAMPLE

Vacation accruals. The client keeps an accurate memorandum control of accrued vacation pay within its payroll system. The client does not post interim accrual adjustments to the general ledger, and prefers as a matter of convenience to leave this to the auditor at year end. Most auditors would agree that this does not constitute a control deficiency because the client:

- Has an accurate record of the accrual
- Knows that the accrual needs to be made
- Would not allow the statements to be released without the adjustment

Depreciation. The client keeps accurate fixed asset detail records, but chooses to leave the calculation and recording of depreciation to the auditor at year-end, because the audit firm has software that allows it to do this more efficiently. The client reviews the depreciation detail before the statements are released and agrees that service lives and depreciation methods are reasonable. Most auditors would agree that is not a control deficiency for reasons similar to those in the accrued vacation example above.
Bad debts. The client keeps an accurate memorandum control of bad debt write-offs during the year and of accounts receivable that are likely uncollectible, but prefers to allow the auditor to make the allowance for doubtful accounts adjustment at year-end. As long as the client is aware that the entry needs to be made and is able to assess its reasonableness, most auditors would not consider this a control deficiency.

Differing circumstances could easily change the auditor’s conclusions about these examples. If the client did not keep any record of accrued vacations, or was unable to intelligently evaluate the depreciation or allowance for doubtful accounts entries, these matters could well rise to the level of significant deficiencies or material weaknesses.

Possible solution. When a material misstatement is not communicated in the management letter as a symptom of a significant deficiency or material weakness, there should usually be a documented explanation. Many auditors find it efficient to record their evaluations directly on, or in conjunction with, their adjusting journal entry sheet. This is an effective way of documenting a decision not to communicate a matter that might otherwise appear to be significant.

Documenting the Understanding of Controls
Auditors are required to document their understanding of internal control. As with risk assessment documentation, professional standards do not specify particular methods of documentation. Structured questionnaire-type documents and narrative memoranda are the most common methods, and each carries with it advantages and disadvantages similar to those discussed above, under Documentation of Risk Assessment. Several implementation problems are common in this area.

“Rolling forward” internal control documentation without update. Internal control documentation is often filed in a permanent file, away from the main body of the audit documentation. It therefore becomes easy to ignore this documentation and to not maintain it from year to year. Failure to update this documentation can also be a conscious decision as a result of time pressures within an audit engagement. This can lead to a more serious consequence, which is the failure to test controls on a proper cycle, when testing would be appropriate.

Internal control documentation does not accurately reflect actual practice. Particularly when an auditor relies heavily on standardized documentation templates for internal control, those templates are sometimes filled out in
a mechanical fashion without giving adequate consideration to underlying reality. This can result from:

- The auditor’s too-ready acceptance of management’s answers on questionnaires or to other inquiries
- Answering questions or completing narratives based on how the auditor (or management) feels that the controls ought to be, or thinks that they are, rather than based on reality
- Considering only the design but not the implementation of the controls

This type of documentation also often results from “manufacturing” a document solely to create the appearance of compliance with standards. This is at best an inefficient use of audit resources. At worst, it creates documentation that gives members of the audit team an incorrect understanding of internal control. This may lead to ineffective or inefficient design or application of further audit procedures.

**Internal control documentation not correlated to risk assessment.** The auditor’s understanding of internal control is an integral part of the risk assessment process. Higher control risk ordinarily indicates a higher risk of material misstatement. However, sometimes internal control documentation is not considered, or is inadequately considered, when assessing audit risk. This can result in risk assessments that are inconsistent with the indicated control risk. For example, when a high inherent risk area, such as percentage-of-completion calculations in a construction business, also has high control risk, it is normally expected that this area will be assessed at high overall risk of material misstatement. If the risk assessment documentation for percentage-of-completion indicated a low risk of material misstatement under these circumstances, that risk assessment would be inconsistent with the inherent and control risk, absent a documented explanation to the contrary.

Because the internal control documentation feeds into the risk assessment process, a break in the logical connection between the two can lead to either over- or under-auditing, as discussed in the Correlation of Risk Assessment to the Design of Further Audit Procedures section above.

**Possible solutions.** Most auditors have an intuitive understanding of internal control. Problems in these areas may arise from:

- Over-reliance on practice aids, to the exclusion of exercising adequate skepticism and diligence in completing them
- Omission of adequate consideration of internal control in audits of ongoing clients due to budgetary constraints
- Premature stoppage of the planning process by not linking internal control to risk assessment
Increased supervisory attention to or involvement in the planning process is usually the first-line solution to this problem.

**STUDY QUESTION**

2. Which of the following situations would most auditors be likely to consider as an indicator of a significant deficiency or material weakness in internal control?

   a. Management keeps a record of bad debt write-offs during the year, and of accounts receivable that are likely to be uncollectible, but chooses to have the auditor make the allowance for doubtful accounts adjustment at year-end. Management reviews and is capable of understanding that entry.

   b. Management lacks the skills and knowledge necessary to evaluate the appropriateness of depreciation methods and the calculation of depreciation expense, and for this reason leaves the annual depreciation adjustment to the auditor at year-end.

   c. Management keeps a record of accrued vacation pay within its payroll system but chooses to leave adjustment of the liability account to the auditor at year-end.

   d. Management does not accrue accounts payable on an interim basis, but provides the auditor with a list of accounts payable for posting as a part of the audit.

**AUDITOR COMMUNICATIONS**

The clarified standards have brought at least one significant change in the requirements for auditor-client communications. Implementation issues from the changes of a few years ago still linger, however, both in communicating internal control matters and in the auditor’s communication with those charged with governance.

**Management Letter**

Standards require that auditors communicate significant deficiencies and material weaknesses to management in writing. One significant change to previous standards is that this communication should now include an explanation of the potential effects of significant deficiencies and material weaknesses. This communication should be made within 60 days of the report release date.

Having a documented oral communication has not been an option for several years. Some auditors either do not understand or do not observe this requirement due to time pressures to conclude the engagement.

This issue is closely related to the documentation of the consideration of significant deficiencies and material weaknesses discussed in the *Internal Control* section above. Failure to evaluate, or incorrectly evaluating, control deficiencies will lead to an incorrect management letter. This has ongoing...
implications for continuing audit clients because control deficiencies that are not correctly communicated to management are unlikely to be remedied.

**Communication with Those Charged with Governance**

Professional standards require the auditor to communicate certain matters to “those charged with governance,” which generally is the board of directors. These communications may be either written or oral, but oral communications should be documented.

This communication does not necessarily take place only at the end of the audit. Although exact timing may vary according to the engagement, it may begin near the start of the audit and continues through the end. Auditors may, for example, communicate certain planning matters during the planning stages. They may also communicate significant difficulties encountered during the audit, especially if those difficulties are likely to result in a modified opinion.

Required elements of this communication include:

- The auditor’s responsibilities
- The planned scope and timing of the audit
- Significant findings or issues form the audit, including:
  - The auditor’s views about qualitative aspects of significant accounting policies and practices
  - Significant difficulties, if any, encountered in the audit
  - Disagreements, if any, with management
  - Other findings or issues
  - Uncorrected misstatements, if any
  - Material corrected misstatements
  - Consultation with other accountants, if any
  - Written representations requested from management

For all but small, owner-managed clients, most auditors agree as a matter of best practice that a formal written communication as envisioned in the standards should be issued.

**Possible Solutions**

Implementation problems with auditor communications often result from:

- Incomplete understanding of the requirements, or
- Omission of these communications due to budgetary pressures or simple oversight in the final stages of the engagement.

The first-line solution to either of these issues usually involves training and staff awareness, reinforced by supervisory review. Most commercially published third-party practice aids contain templates for the standardized portions of the wording of these communications. The communication in each case requires careful attention to engagement-specific matters.
STUDY QUESTION

3. All of the following statements apply to the auditor’s communication of significant deficiencies and material weaknesses to management except:
   a. The communication should be written.
   b. The communication should include an explanation of the potential effects of significant deficiencies and material weaknesses.
   c. The communication should be made within 60 days of the report release date.
   d. The communication should be documented when it is made orally.

REPORTING

If the profession’s reception of the reporting requirements of Statement of Standards on Accounting and Review Services No. 19 (SSARS 19) for compilations and reviews is any indication, the profession is likely to be in for some difficulty in implementing the new form and content of the auditor’s report which took effect for audits of periods ended on or after December 15, 2010.

SSARS 19 brought about the most sweeping changes to reporting practices for compilations and reviews in the last 20 years. In spite of extensive advance publicity from the AICPA, a significant number of practitioners failed to implement these changes. Peer reviews have detected these failures, sometimes into the second year after the effective date of SSARS 19.

Implementation of New Report Format

The form of the new audit report is greatly different from the familiar report under previous standards. It contains significantly expanded discussion of the auditor’s responsibility as contrasted with management’s. There are paragraph headings for:

- Management’s responsibility for the financial statements
- The auditor’s responsibility
- The auditor’s opinion

The paragraph covering management’s responsibility is standardized language. It is important to note that the new standard prohibits any elaboration in the auditor’s report about management’s responsibility, or any reference to another document that does so. This might lead users of the report to the erroneous conclusion that the auditor is expressing assurances about any representations made by management about its responsibilities.

When it also covers other legal or regulatory requirements, the report contains headings that separate the report on the financial statements from the report on the other requirements.
OBSERVATION

This new auditor’s report is consistent with one of the overarching philosophical thrusts of the AICPA professional standards in the 21st century, which is to draw a clear distinction between the responsibilities of the auditor and of management for the financial statements.

Possible Solutions

If there are problems encountered in correctly adopting the new audit report, it will likely be due to one of two causes:

- Lack of awareness of changing standards
- Simple staff and supervisory neglect to update the old reporting templates on specific engagements from the previous year

Preventing or correcting issues should start with obtaining an awareness of the new report form and content. This can be done through formal continuing education programs, informal self-study, and staff meetings or memoranda. This should extend to clerical staff because they may be the firm’s first line of defense in seeing that reporting templates are timely updated. In addition, pre-issuance supervisory review in the final stages of the engagement should be targeted toward correct reporting.

STUDY QUESTION

4. The new auditor’s report:
   a. Has not changed significantly from the report required under previous standards
   b. Contains a paragraph that describes the auditor’s responsibility
   c. Allows the auditor to tailor description of management’s responsibility for the financial statements based on the circumstances of the engagement
   d. May not also report on other legal or regulatory requirements

OPENING BALANCES

The new clarified standards make it explicit that reviewing a predecessor’s audit documentation cannot be the only procedure performed to obtain sufficient appropriate evidence regarding opening balances in initial audits. This is a significant departure from previous practice.

The auditor’s objectives, according to the new standards, are to obtain sufficient appropriate evidence about whether:

- Opening balances contain misstatements that materially affect the current period’s financial statements.
Accounting policies reflected in the opening balances have been consistently applied in the current period’s financial statements.

Changes in accounting policies have been properly accounted for, adequately presented, and disclosed in accordance with the applicable financial reporting framework.

Procedures to address these requirements include:

- Determining whether prior period closing balances are brought forward correctly
- Determining whether opening balances reflect appropriate application of accounting policies
- Evaluating whether current period audit procedures provide evidence about opening balances by means of performing one or both of the following:
  - Performing specific procedures related to opening balances
  - Reviewing predecessor auditor’s work

Review of the predecessor’s work may provide evidence about opening balances and consistent application of accounting principles. But the nature, timing, and extent of audit work performed and conclusions reached on the current period audit are the sole responsibility of the current auditor. The auditor’s determination of whether to rely on evidence obtained as a result of reviewing the predecessor auditor’s work is influenced by the auditor’s assessment of the predecessor’s professional competence and independence.

**Possible Solutions**

If implementation problems for this standard develop, they will most likely stem from:

- Lack of awareness of the new requirements
- Inadvertent omission of required audit procedures due to the non-routine nature of an initial audit

Lack of awareness of the requirement would be addressed through formal continuing education programs, informal self-study, and staff meetings or memoranda. Omission of procedures because “someone forgot about them” highlights the fact that initial audits may not be routine engagements within any particular firm. This points to the need for increased supervisory involvement in the planning phases of these engagements. Most published third-party practice aids contain a program or checklist for this purpose.
**STUDY QUESTION**

5. Under the new standards, the conclusions regarding opening balances in an initial audit are the responsibility of:
   a. The predecessor auditor
   b. The entity’s management
   c. The current period auditor
   d. Those charged with governance

**QUALITY CONTROL**

The clarified auditing standards now reference the Statements on Quality Control Standards (SQCS), which incorporates them into the auditing literature.

**Documentation of the Quality Control System**

An important change in the quality control standards in 2009 was the requirement for all firms with an audit or accounting practice to have a written quality control document. This requirement applies to firms that have only compilation practices, as well as to auditing firms. Even though firms with only compilation-and-review practices qualify to have their peer review done as an engagement review rather than a system review, and thus their peer reviewers will never look at their quality control documents, this requirement is still in place. Documentation of the quality control (QC) system continues to be a problem for some small and mid-sized firms.

**Possible solution.** Documenting a system of quality control need not be an exhaustive exercise for most firms. The AICPA Peer Review Program Manual (PRM) contains two questionnaires, one for sole practitioners with no personnel and one for firms with two or more personnel. According to the PRM, a firm may elect to have one of these completed questionnaires serve as the firm’s quality control document. These questionnaires, when properly completed, supplemented with brief narratives, and in some cases given minor tailoring to fit the firm’s practice, will make most small firms compliant with the SQCS requirement. The questionnaires are accessible through the AICPA’s Web site. Many firms will find that this is an expedient and altogether adequate and effective means of documenting their QC systems.

Mid-sized and large firms will usually find it necessary to have a customized QC document. The AICPA has illustrative QC documents for firms of various sizes, as do some of the commercial practice aid publishers. Firms that use any externally composed illustrative document for this purpose should be very careful to tailor it to the specific needs of the firm’s practice. Adopting in a wholesale fashion a “canned” QC document inevitably leads
to setting requirements that do not make sense for the individual firm, and that will lead either to inefficient practice or to noncompliance with the document’s requirements.

**Engagement Quality Control Review**

Engagement quality control review (EQCR) was introduced into the quality control standards in 2009. Results of peer reviews conducted in 2009 through 2012 indicate that many firms still do not understand EQCR. Its two key elements are that:
- It is a pre-issuance review procedure.
- It is conducted by persons with no previous connection to the engagement.

**The most common misconceptions about EQCR include:**
- Mistaking EQCR for pre-issuance review conducted by the engagement partner or other members of the engagement team
- Mistaking EQCR for post-issuance reviews, such as inspections that are conducted in connection with the firm’s monitoring program
- Mistakenly believing that all engagements should be subjected to EQCR
- Failing to specify objectively determinable criteria for engagements to be subjected to EQCR
- Writing inappropriate or impractical EQCR criteria, such as:
  - All audit and accounting engagements. Such a criterion is far in excess of what would be practicable for most firms, unless the firm has a very small audit and accounting practice. It would be so expensive that it would not likely be observed consistently.
  - All audit (or all review or all full-disclosure) engagements. This criterion might be appropriate for a firm that does only one or a very few of any of these engagements. For any firm that performs numerous such engagements, this would create the same problem as the criterion immediately above.
  - Only those engagements that in the engagement partner’s judgment should be subjected to EQCR. This criterion is inappropriate because it is not specific enough. It leaves the decision entirely up to the engagement partner, which is contrary to the intent of the standard. EQCR criteria have to be objective enough that an engagement that falls within them will be readily determinable. However, it is legitimate to include one or more subjective criteria like this one along with other objectively determinable criteria, so that jobs that have some characteristic that is not covered by the firm’s other criteria could be selected based on a subjective determination. This could be nothing more than the engagement partner’s feeling of not “being comfortable” with the engagement.
Other criteria that the firm does not reasonably expect to comply with on a consistent basis. This would cause the firm to have a compliance deficiency in the application of its QC system, and could lead to finding or deficiencies in its peer review, especially if deficiencies are found in specific engagements that should have been detected by EQCR.

It is legitimate to write EQCR criteria such that only once in a great while would any engagement fall under them. This might not be appropriate for firms with diverse and complex practices, or for growing firms that are frequently taking on clients and engagements in new industries and levels of service. On the other hand, stable firms with specialty practices that do not often take on new clients and that seldom venture outside of their specialty areas might safely adopt criteria (such as accepting an engagement outside of its area of specialization) that it only rarely expects an engagement to meet.

**Possible solutions.** Practical problems in implementing EQCR vary greatly depending on firm size and practice nature.

**Small firms.** The most obvious problem for the small firm is that the EQCR has to be conducted by a qualified person who was not a part of the engagement team. For a sole practitioner, this is impossible without going outside the firm. For a two- or three-partner firm, all of the partners might be on the engagement team, or partners other than the engagement partner might be “tax partners” who might not be qualified to review complex issues involving auditing or financial accounting standards.

The practical approach to this problem is to engage another firm or practitioner to perform the EQCR. Some small firms have reciprocal arrangements with other firms, either of their same size or larger, to do EQCRs on each other’s work. For firms that do not have such arrangements, or for situations that call for expertise that the other firm does not have, the AICPA’s directory of peer reviewers is a good source of potential outside EQCR reviewers, because it lists peer reviewers by firm size and by categories of industry and engagement experience. For a typical small-firm engagement, an EQCR would not ordinarily take more than a few hours. Most such engagements get selected because of some particular engagement characteristic, such as an industry-specific accounting principle, or a contentious or highly risky issue. Firms should signal these characteristics to the EQCR reviewer for special attention. Documentation, although required, need not be elaborate or lengthy. Many firms find it efficient to use the engagement checklists contained in the AICPA *Peer Review Program Manual* to document the EQCR.
Mid-sized and large firms. Practical problems in EQCR implementation for mid-sized and large firms often include:

- Timely identification of engagements that are subject to EQCR
- Scheduling EQCR so that the release of the report is not unduly delayed
- Defining the degree to which an EQCR reviewer can be consulted during the engagement without losing objectivity, and effectively becoming a part of the engagement team

Solutions to these issues most often involve staff and partner awareness of the standards. It is efficient to consider, in the planning stages, whether an engagement has characteristics that will cause it to be subject to EQCR, while keeping in mind that additional characteristics may arise during the course of the job. With this in mind, time for the EQCR can be built into the budget, and an EQCR reviewer identified.

During the course of an engagement, circumstances may arise that would call for EQCR on an engagement that did not initially meet the firm’s criteria. Staff should be made aware of EQCR criteria so that they can timely identify these circumstances and communicate them to firm management.

**STUDY QUESTION**

6. Which of the following best applies to EQCR?

   a. All audit engagements should be subjected to EQCR.
   b. EQCRs should be conducted by persons with no previous connection to the engagement.
   c. EQCR is a pre-issuance review conducted by the engagement partner or other members of the engagement team.
   d. EQCR is a post-issuance review conducted in connection with the firm’s monitoring program.

**CPE NOTE:** When you have completed your study and review of chapters 4-7, which comprise Module 2, you may wish to take the Quizzer for this Module.

Go to [CCHGroup.com/PrintCPE](http://CCHGroup.com/PrintCPE) to take this Quizzer online.
LEARNING OBJECTIVES

Upon completion of this chapter, the reader should be able to:

- Recognize situations in which SAS 124 applies
- Explain the applicability of U.S. generally accepted auditing standards and other auditing standards to engagements to audit foreign GAAP financial statements
- Explain the auditor's responsibilities in reporting on foreign GAAP financial statements

INTRODUCTION

Statement on Auditing Standards No. 124, Financial Statements Prepared in Accordance with a Financial Reporting Framework Generally Accepted in Another Country (SAS 124), addresses circumstances in which an auditor in the United States is engaged to report on financial statements that have been prepared in accordance with a financial reporting framework generally accepted in another country (foreign GAAP).

Applicability

SAS 124 applies when:

- The foreign GAAP has not been adopted by a body designated by the AICPA Council to establish accounting principles. Those bodies presently are the:
  - Federal Accounting Standards Advisory Board
  - Financial Accounting Standards Board (FASB)
  - Government Accounting Standards Board
  - International Accounting Standards Board (IASB), which currently establishes International Financial Reporting Standards (IFRS)
- The statements are intended for use outside the United States.
- The statements are prepared in accordance with a jurisdictional variation of IFRS.

SAS 124 does not apply to engagements to report on the financial statements of a U.S. subsidiary of a foreign registrant parent company that are presented in the parent company's filing with the U.S. Securities and Exchange Commission.
SAS 124 is not intended to prohibit the use of foreign GAAP statements within the United States.

Effective Date
SAS 124 is effective for audits of financial statement periods ending on or after December 15, 2012.

STUDY QUESTION

1. Which of the following statements best describes the applicability of SAS 124?
   a. SAS 124 prohibits the use of foreign GAAP financial statements within the United States.
   b. SAS 124 applies to financial statements prepared in accordance with standards established by the IASB.
   c. SAS 124 applies to statements of a U.S. subsidiary of a foreign registrant parent company that are presented in the parent company's filing with the Securities and Exchange Commission.
   d. SAS 124 applies to financial statements that are intended for use outside the United States.

OBJECTIVES

Engagements to report on statements prepared in accordance with foreign GAAP bring with them special considerations. The auditor's objective is to appropriately address those considerations as they relate to:
- Engagement acceptance
- Planning the engagement
- Performing the engagement
- Forming an opinion and reporting on the financial statements

REQUIREMENTS

SAS 124 sets forth presumptively mandatory requirements in four broad categories. These requirements are signaled in the Standards by the word "should." SAS 124 contains no unconditional requirements.

Considerations When Accepting the Engagement

Auditors are required in all audit engagements to determine the acceptability of the financial reporting framework (formerly known as "basis of accounting") applied in preparing the financial statements. In audits of foreign GAAP statements, auditors should obtain an understanding of:
- The purpose for which the statements are prepared
- Whether the financial reporting framework is a fair-presentation framework. This term refers to a financial reporting framework that:
— Requires compliance with the requirements of the framework
— Acknowledges that it may necessary for management to provide disclosures beyond those specifically required
— Acknowledges that it may necessary to depart from a requirement of the framework in order to achieve fair presentation

- The intended users of the statements
- The steps taken by management to determine acceptability of the financial reporting framework in the circumstances

**Observation**

In considering the intended users and the financial reporting framework, auditors may wish to take into account whether the users are likely to be familiar with the framework. If the statements are to be used both within and outside of the U.S., the auditor might consider the relationship between the users and the entity, and whether the statements are to be used in a manner that permits the users to discuss with the entity the differences between U.S. and foreign GAAP and their significance. Thus, an auditor might conclude that it would not be appropriate, for example, to use foreign GAAP statements in a widely distributed public placement memorandum within the United States.

When auditors plan to use the form and content of another country’s auditor’s report, they should gain an understanding of the applicable legal responsibilities involved.

**Observation**

The auditors’ reports of other countries may convey different meanings and entail different legal responsibilities, due to either law or culture, than U.S. auditors’ reports, even when they appear to be similar. They may, for example, require the auditor to report on statutory compliance, or otherwise require understanding of local laws and regulations. Auditors may find it advisable to consult experts in the reporting practices and the related legal responsibilities of the foreign country.

**Performance**

Auditors should comply with U.S. generally accepted auditing standards (GAAS) when auditing foreign GAAP statements that are intended for use only outside the United States, except for requirements related to the form and content of report.

Auditors should determine whether the application of GAAS requires special considerations under the circumstances of the engagement. This might occur due to differences between U.S. and foreign GAAP that would affect the auditor’s risk assessment and thus the design of further audit procedures. Foreign GAAP may, for example:
Require revaluation of assets for inflation. In this case, the auditor may consider it necessary to test the revaluation adjustments.

Prohibit recognition of deferred taxes. In this case, procedures for testing deferred taxes would not apply.

Auditors should obtain an understanding of foreign GAAP in order to understand the entity’s selection and application of accounting policies.

**OBSERVATION**

Reading the professional literature or statutes of the other country may help to establish an understanding of foreign GAAP. However, the application of GAAP to particular situations often requires practical experience. Auditors may find it advisable to consult experts in the GAAP of the foreign country.

**Application of Auditing Standards of Another Country**

When an engagement to audit statements prepared under a foreign GAAP includes a requirement to apply either the GAAS of the foreign country or International Auditing Standards (ISAs), the auditor should:

- Obtain an understanding of relevant standards
- Apply those standards as well as U.S. GAAS, except for requirements related to the form and content of the report

**OBSERVATION**

Applying either the ISAs or foreign GAAS may require auditors to perform procedures in addition those required by U.S. GAAS. Reading the professional literature or statutes of the other country may help to establish an understanding of foreign GAAS. However, that literature may not always present a complete description of the auditing practices of the other country. Auditors may find it advisable to consult experts who have practical experience with the foreign GAAS.

**STUDY QUESTION**

2. When engaged to audit foreign GAAP statements that are intended for use only outside the United States, the auditor should apply:
   a. The GAAS of the foreign country
   b. The ISAs
   c. U.S. GAAS
   d. Both U.S. GAAS and the GAAS of the foreign country
Reporting
Requirements for reporting vary depending on whether the report is to be used within the United States.

Use only outside the United States. When reporting on statements prepared under a foreign GAAP that are intended solely for use outside the United States, the auditor should report using either:

- A U.S. form of report that reflects that the statements have been prepared in accordance with a foreign GAAP, including the following elements:
  - A title including the word “independent”
  - The addressee
  - An introductory paragraph identifying the entity, the statements audited, and the dates or periods covered
  - A section describing management’s responsibility for the financial statements
  - A section describing the auditor’s responsibility
  - The auditor’s opinion
  - A reference to the note to the financial statements that describes the basis of presentation
  - Identification of the country of origin of the foreign GAAP
  - The auditor’s signature, city, and state
  - The date of the auditor’s report

Or,
- The report form and content of the foreign country, or if applicable, the ISAs, provided that:
  - A similar report would be issued by auditors of that country under the circumstances.
  - The auditor understands and has gathered sufficient appropriate evidence to support the assertions contained in the auditor’s report.
  - The auditor has complied with that country’s reporting standards and identifies the country in the report.

Use in the United States. If the foreign GAAP statements are also intended for use within the U.S., auditors should:

- Report using the U.S. form of report
- Include in the report an emphasis of a matter paragraph that contains:
  - Identification of the financial reporting framework used
  - A reference to the note to the financial statements that describes the basis of presentation
  - An indication that the foreign GAAP differs from U.S. GAAP
SAS 124 contains an exhibit that illustrates U.S. forms of reports that are intended for use only outside the United States, and for use in the United States.

**OBSERVATION**

When reporting on foreign GAAP statements that will be used both inside and outside the United States, auditors may issue two separate reports, as described above: one for use outside the United States, and one for use inside.

**STUDY QUESTION**

3. In reporting on foreign GAAP statements that are intended for use both inside and outside the United States, auditors:
   
   a. May issue one report for use outside the United States, and one for use inside
   b. Should use the report form and content of the ISAs
   c. Must use the report form and content of the foreign country
   d. Should quantify the effects on the financial statements of departures from U.S. GAAP
LEARNING OBJECTIVES

Upon completion of this chapter, the reader should be able to:

- Identify supplementary information and required supplementary information and distinguish them from other information in documents containing audited financial statements
- List the professional requirements related to supplementary information, required supplementary information, and other information in documents containing audited financial statements
- Explain the reporting requirements for supplementary information and required supplementary information in audit, review, and compilation engagements

INTRODUCTION

Recent years have seen many changes in the professional standards for reporting on information that accompanies the basic financial statements. This course summarizes the requirements and guidance for that reporting in audit, review, and compilation engagements.

The professional requirements and guidance for reporting on information that accompanies the basic financial statements is currently contained in the following publications:

Auditing Literature

- Statement on Auditing Standards No. 118, Other Information in Documents Containing Audited Financial Statements (SAS 118)
- Statement on Auditing Standards No. 119, Supplementary Information in Relation to the Financial Statements as a Whole (SAS 119)
- Statement on Auditing Standards No. 120, Required Supplementary Information (SAS 120)
- Interpretation No. 1 of AU Section 551, Supplementary Information in Relation to the Financial Statements as a Whole

Compilation and Review Literature

- AR Section 80, Compilation of Financial Statements (SSARS 19), paragraph .53
- AR Section 90, Review of Financial Statements (SSARS 19), paragraph .60
- AR Section 9080, Compilation of Financial Statements: Accounting and Review Services Interpretations of Section 80
- AR Section 9090, Review of Financial Statements: Accounting and Review Services Interpretations of Section 90
This course covers only the reporting aspects of these requirements and guidance. It does not cover the performance issues that auditors or accountants may be required to or may elect to address, such as auditing, compilation, or review procedures to be applied to such information.

DEFINITIONS

Professional literature establishes the following definitions.

Other Information

*Other information* consists of financial and nonfinancial information other than the financial statements and auditor’s report that is included in a document that contains audited financial statements and the auditor’s report on those statements. SAS 118 specifically excludes from this definition required supplementary information.

Required Supplementary Information

*Required supplementary information* is defined as information that a designated accounting standard setter requires to accompany an entity’s basic financial statements. Required supplementary information is not part of the basic financial statements, however:

- A designated accounting standard setter considers the information to be an essential part of the financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context.
- Authoritative guidelines for the methods of measurement and presentation of the information have been established.

**OBSERVATION**

The bodies presently designated as accounting standards setters are the:

- Financial Accounting Standards Board (FASB)
- Governmental Accounting Standards Board (GASB)
- Federal Accounting Standards Advisory Board (FASAB)
- International Accounting Standards Board (IASB)

Supplementary Information

*Supplementary information* is information presented outside the basic financial statements, excluding required supplementary information, that is not considered necessary in order for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Supplementary information may be presented in a document containing the audited financial statements, or separately from the financial statements.
OBSERVATION

Tables 1, 2 and 3, at the conclusion of this course, contain examples to assist the reader in identifying other information, supplementary information, and required supplementary information, and in distinguishing between them.

STUDY QUESTION

1. The term *supplementary information* is best defined as:
   
   a. Information that a designated accounting standard setter requires to accompany an entity’s basic financial statements
   
   b. Information presented outside the basic financial statements that is not considered necessary in order for the financial statements to be fairly presented in accordance with the applicable financial reporting framework
   
   c. Financial information other than the financial statements and auditor’s report that is included in a document that contains audited financial statements and the auditor’s report on those statements
   
   d. Nonfinancial information other than the financial statements and auditor’s report that is included in a document that contains audited financial statements and the auditor’s report on those statements

AUDITING STANDARDS

Reporting on Supplementary Information

*Standard report.* When supplementary information is presented with the audited financial statements, the auditor should report on it in either:

- An other-matter paragraph following the opinion paragraph of the independent auditor’s report on the financial statements, or
- A separate report on the supplementary information

That other-matter paragraph or separate report should contain statements to the effect that:

- The audit was conducted for the purpose of forming an opinion on the financial statements as a whole.
- The supplementary information is presented for purposes of additional analysis, and is not a required part of the financial statements.
- The supplementary information is management’s responsibility.
- The supplementary information was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements.
- The supplementary information has been subjected to the auditing procedures applied in the audit of the financial statements, and
certain additional procedures, including comparing and reconciling it to the financial statements or underlying records, and other additional procedures.

- In the auditor’s opinion, the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, in cases where the auditor has both:
  - Issued an unqualified opinion on the financial statements
  - Concluded that the supplementary information is fairly stated in all material respects, in relation to the financial statements as a whole.

**OBSERVATION**

SAS 119 introduced two significant new assertions to the auditor’s report:

- That the supplementary information was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements
- That the supplementary information has been subjected to certain additional auditing procedures, which include comparing and reconciling it to the financial statements or underlying records, and other additional procedures

That the AICPA has “hard-coded” these assertions into the new required report language signifies that it intends to have readers of the report better understand the nature of the supplementary information, its relation to the financial statements, and the nature and limitations of the audit procedures applied.

**STUDY QUESTION**

2. SAS 119 has changed the required report wording for supplementary information by adding a statement that was not required under previous standards, to the effect that:

   a. The supplementary information has been subjected to the auditing procedures applied in the audit of the financial statements.
   b. The audit was conducted for the purpose of forming an opinion on the financial statements as a whole.
   c. The supplementary information is presented for purposes of additional analysis, and is not a required part of the financial statements.
   d. The supplementary information has been derived from and relates directly to the underlying accounting and other records used to prepare the financial statements.

**Example standard report.** Exhibit A under the application and other explanatory material to SAS 119 provides the following example of a “standard” report on supplementary information, when the auditor is issuing
an unqualified opinion on the financial statements and has concluded that
the supplementary information is fairly stated, in all material respects, in
relation to those financial statements as a whole. This wording should appear
as an other-matter paragraph after the opinion paragraph in the independent
auditor’s report on the financial statements.

Our audit was conducted for the purpose of forming an opinion
on the financial statements as a whole. The [identify accompanying
supplementary information] is presented for purposes of additional
analysis and is not a required part of the financial statements. Such
information is the responsibility of management and was derived
from and relates directly to the underlying accounting and other
records used to prepare the financial statements. The information
has been subjected to the auditing procedures applied in the au-
dit of the financial statements and certain additional procedures,
including comparing and reconciling such information directly to
the underlying accounting and other records used to prepare the
financial statements or to the financial statements themselves, and
other additional procedures in accordance with auditing standards
generally accepted in the United States of America. In our opinion,
the information is fairly stated in all material respects in relation to
the financial statements as a whole.

Modifications to the standard report. When a qualified opinion has been
issued on the basic financial statements, and the qualification affects the
supplementary information, the other-matter paragraph or report should
also contain a statement that except for the effects of the matter discussed
in the paragraph in the auditor’s report explaining the qualification, the
supplementary information is fairly stated, in all material respects, in relation
to the financial statements as a whole.

When an adverse opinion or a disclaimer of opinion on the financial
statements has been issued, the auditor is prohibited from expressing an
opinion on the supplementary information. In such cases the auditor may,
when permitted by law or regulation, withdraw from the engagement to
report on the supplementary information. When the auditor does not
withdraw, the report on the supplementary information should state that
because of the significance of the matter disclosed in the auditor’s report,
it is inappropriate to, and the auditor does not, express an opinion on the
supplementary information.

A separate report on the supplementary information is required when
that information is not presented together with the audited financial
statements. The report should be dated no earlier than the date on which the
auditor completed the required auditing procedures on the supplementary information. That report should include, in addition to the elements listed in the preceding section:

- A reference to the report on the financial statements
- The date of that report
- The nature of the opinion expressed on the financial statements
- Any report modifications

Auditors may consider restricting the use of their separate reports on supplementary information to appropriate specified parties in order to avoid misunderstanding or misinterpreting supplementary information that is presented separately from the financial statements.

When the auditor concludes that the supplementary information is materially misstated in relation to the financial statements as a whole, the auditor should discuss the finding with management and propose appropriate revisions. When management declines to revise the supplementary information, the auditor should either:

- Modify the opinion on that information and describe the misstatement in the auditor’s report, or
- Withhold the report on the supplementary information, if a separate report is to be issued

Exhibit A to SAS 119 also contains example wording for the following situations:

- An other-matter paragraph for a qualified opinion on financial statements and qualified opinion on supplementary information
- An other-matter paragraph relative to supplementary information when disclaiming opinion on the financial statements
- An other-matter paragraph relative to supplementary information when issuing an adverse opinion on the financial statements
- Separate reports on supplementary information:
  - Unqualified opinion on the financial statements and unqualified opinion on the supplementary information
  - Qualified opinion on the financial statements and qualified opinion on the supplementary information
  - Disclaimer of opinion on the financial statements
  - Adverse opinion on the financial statements

**Auditing interpretation.** The AICPA has issued an interpretation addressing the case when an auditor completes required procedures on supplementary information subsequent to the date of the auditor’s report on the basic financial statements. It explains how the auditor may make it clear that no
additional procedures were performed on the audited financial statements subsequent to the report date on those statements.

The auditor’s report on supplementary information should not be dated prior to the completion of the procedures required in SAS 119 for the supplementary information. When the auditor completes those procedures after the date of the auditor’s report on the basic financial statements, there is no requirement to obtain additional evidence about the audited financial statements. However, this interpretation states that although not required, the auditor may include in a separate report on supplementary information language to the effect that:

We have not performed any procedures with respect to the audited financial statement subsequent to [date of the auditor’s report on those statements].

When the auditor reissues a report on the audited financial statements to include an explanatory paragraph that reports on the supplementary information, that report may be dual-dated to indicate that the reporting on the supplementary information is as of a later date than the original report on the basic financial statements.

**Reporting on Required Supplementary Information**

**Standard report.** The standard auditor’s report is appropriate when the following conditions are met:
- All of the required supplementary information is included.
- The auditor has applied the procedures specified in SAS 120.
- No material departures from the prescribed guidelines have been identified.

That report takes the form of an explanatory paragraph appearing immediately after the opinion paragraph in the independent auditor’s report on the basic financial statements.

**OBSERVATION**

This reporting requirement represents a significant change to previous standards. Under those standards, auditors were not required to add such an explanatory paragraph unless there were circumstances that would have led to a modified report on the required supplementary information. There was no requirement for an explanatory paragraph otherwise.
Example standard report. Exhibit A to SAS 120 presents the following example of a standard explanatory paragraph:

[Identify the applicable financial reporting framework, such as “accounting principles generally accepted in the United States of America”) require that the [identify the required supplementary information] on page XX be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by [identify designated accounting standard setter, such as FASB or GASB] who considers it to be an essential part of financial reporting for placing the basic financial statements in appropriate operational, economic or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management’s responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

The discussion of the auditor’s responsibility for required supplementary information is included in the auditor’s report because that information accompanies the basic financial statements. The required supplementary information is not, however, a part of the basic financial statements. Therefore, the required supplementary information does not affect the auditor’s opinion on the basic financial statements, even if it is omitted in whole or in part. Furthermore, the auditor has no obligation to present that information if the entity chooses to omit it.

Observation

There is no provision for a separate auditor’s report on required supplementary information because such information would never be presented apart from the basic financial statements.

Modifications to the standard report. SAS 120 addresses other circumstances in which a standard report on the required supplementary information is not appropriate. In those cases, the explanatory paragraph should include, as necessary, language to explain the following:
All of the required supplementary information is omitted. In this case, the explanatory paragraph should state that:

- Management has omitted [describe the missing required supplementary information] that [identify the applicable financial reporting framework, such as U.S. GAAP] require to be presented to supplement the basic financial statements.
- Such missing information, although not a part of the basic financial statements, is required by [identify the designated accounting standard setter, such as FASB or GASB], who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic or historical context.
- The auditor’s opinion on the basic financial statements is not affected by the missing information.

Some of the required supplementary information is omitted, and some is presented in accordance with the prescribed guidelines. In this case, the explanatory paragraph should contain appropriately adapted language similar to that appearing immediately above, for when all such information is omitted.

Material departures from the prescribed guidelines have been identified by the auditor. The explanatory paragraph should, in this case, contain:

- A statement that although the auditor’s opinion on the basic financial statements is not affected, material departures from the prescribed guidelines exist
- A description of those departures

The auditor is not able to complete the procedures required by SAS 120, in which case the explanatory paragraph should state:

- That the auditor was unable to apply certain limited procedures to the required supplementary information in accordance with U.S. GAAS
- The reasons for the inability to apply those procedures
- That the auditor does not express an opinion or provide any assurance on the information

The auditor has unresolved doubts about whether the required supplementary information is presented in accordance with the prescribed guidelines. The explanatory paragraph should, in this case, contain a statement that although the auditor’s opinion on the basic financial statements is not affected, the results of the limited procedures have raised doubts about whether material modifications should be made to the required supplementary information in order for it to be presented in accordance with guidelines established by [identify designated accounting standard setter, such as FASB or GASB].
Exhibit A to SAS 120 also provides example report wording addressing the following circumstances:

- All required supplementary information is omitted.
- Some required supplementary information is omitted, and some is presented in accordance with prescribed guidelines.
- Material departures from prescribed guidelines are identified.
- Procedures specified in SAS 120 are not completed.
- Unresolved doubts exist as to whether the required supplementary information is in accordance with prescribed guidelines.

**STUDY QUESTION**

3. Which of the following statements best applies to the auditor’s report on required supplementary information?

   a. Omission of required supplementary information should lead the auditor to express a qualified or adverse opinion on the basic financial statements.
   b. Omission of required supplementary information may cause the auditor to withhold an opinion on the basic financial statements.
   c. A material misstatement within the required supplementary information does not affect the auditor’s opinion on the basic financial statements.
   d. The report may take the form of an other-matters paragraph after the opinion paragraph in the auditor’s report on the basic financial statements, or it may be a separate report.

**Other Information**

SAS 118 does not require auditors to report on other information. It does, however, impose the responsibility to consider the effects of material inconsistencies or misstatements of fact on the financial statements and the related auditor’s report. Uncorrected material inconsistencies may lead the auditor to modify the report on the financial statements, or to withhold the report. Uncorrected material misstatements of fact, because they do not relate directly to the financial statements, would not cause a modification of the auditor’s report; however, they might cause the auditor to withhold the report.

The application and other explanatory material of SAS 118 present the following example of an explanatory paragraph that an auditor may use to disclaim an opinion on other information.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements as a whole. The [identify other information] is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and accordingly, we do not express an opinion or provide any assurance on it.
STUDY QUESTION

4. Which of the following statements best describes the auditor’s reporting responsibilities for other information under SAS 118?

a. SAS 118 requires auditors to consider the effects of material inconsistencies or misstatements of fact on the financial statements and the related auditor’s report.

b. SAS 118 requires auditors to disclaim an opinion on other information in an other-matters paragraph in the auditor’s report on the financial statements.

c. SAS 118 requires auditors to report on other information.

d. SAS 118 requires auditors to withhold their reports on the financial statements when uncorrected material misstatements of fact are identified.

COMPILATION AND REVIEW STANDARDS

Compilation Standards

Supplementary information. SSARS 19 addresses situations in which compiled basic financial statements are accompanied by supplementary information. It requires that:

- The accountant clearly indicate the degree of responsibility, if any, taken with respect to the supplementary information.

- When the accountant has compiled both the basic financial statements and supplementary information, the accountant’s report should refer to the supplementary information, or a separate report on that information should be issued.

- If a separate report is issued, it should state that:
  - The other data accompanying the financial statements are presented for purposes of additional analysis
  - The information has been compiled from information that is the representation of management, without audit or review
  - The accountant does not express an opinion or provide any assurance on such data.

Required supplementary information. SSARS 19 does not address situations in which basic financial statements are accompanied by required supplementary information. The AICPA has issued an interpretation to SSARS 19 (AR Section 9080, Compilation of Financial Statements: Accounting and Review Services Interpretations of Section 80) that addresses the accountant’s responsibilities for this information.

This interpretation states that the accountant is not required to apply procedures to any information presented for supplementary analysis purposes. This includes required supplementary information. However, nothing prohibits an accountant from compiling this information if engaged to do so.
This interpretation describes how the accountant may modify the standard compilation report by including a separate paragraph that refers to the required supplementary information and explains the circumstances regarding its presentation. That paragraph follows the paragraph describing the accountant’s responsibility.

**Example explanatory paragraphs.** When the required supplementary information is presented and the accountant did not compile it, this paragraph may read as follows:

Accounting principles generally accepted in the United States of America [or other applicable financial reporting framework, such as cash or tax basis] require that [identify the required supplementary information] on page XX be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by [identify the designated accounting standard setter, such as the FASB], which considers it to be an essential part of financial reporting and for placing the basic financial statements in an appropriate operational, economic, or historical context. Such information was not audited, reviewed, or compiled by us and, accordingly we do not express an opinion or provide any assurance on it.

When all required supplementary information is omitted, this paragraph may read as follows:

Management has omitted [describe the omitted required supplementary information] that accounting principles generally accepted in the United States of America [or other applicable financial reporting framework, such as cash or tax basis] require to be presented to supplement the basic financial statements. Such missing information, although not a part of the basic financial statements, is required by [identify the designated accounting standard setter, such as the FASB], which considers it to be an essential part of financial reporting and for placing the basic financial statements in an appropriate operational, economic, or historical context.

This interpretation also provides example wording for the following circumstances:

- The required supplementary information is included, the accountant compiled the information, and no material departures from the prescribed guidelines have been identified.
- Some required supplementary information has been omitted and some is presented in accordance with prescribed guidelines.
- Material departures from prescribed guidelines were noted while compiling the required supplementary information.
STUDY QUESTION

5. Which of the following statements best applies to the accountant’s reporting responsibilities for required supplementary information?
   
   a. The accountant is required by SSARS 19 to apply compilation procedures to required supplementary information.
   
   b. If a separate report on required supplementary information is issued, it should state that the information has been compiled from information that is the representation of management, without audit or review.
   
   c. The interpretation to SSARS 19 provides example wording for an explanatory paragraph the when the required supplementary information is presented and the accountant did not compile it.
   
   d. The interpretation to SSARS 19 requires the accountant to modify the standard compilation report by including a separate paragraph that refers to the required supplementary information and explains the circumstances regarding its presentation.

Review Standards

Supplementary information. SSARS 19 addresses situations in which reviewed basic financial statements are accompanied by supplementary information. It requires that:

- The accountant clearly indicate the degree of responsibility, if any, taken with respect to the supplementary information.
- When the accountant has reviewed the basic financial statements, an explanation regarding the supplementary information should be included in the review report or in a separate report.
- The report should state that the review was made for the purpose of expressing a conclusion that there are no material modifications that should be made to the financial statements in order for them to be in conformity with the applicable financial reporting framework, that the other data accompanying the financial statements are presented only for purposes of additional analysis, and that the other data have either:
  - Been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, and the accountant did not become aware of any material modifications that should be made to such data, or
  - Not been subjected to the inquiry and analytical procedures applied in the review of the basic financial statements, but were compiled from information that is the representation of management, without audit or review, and the accountant does not express an opinion or provide any assurance on such data.
**Required supplementary information.** SSARS 19 does not address situations in which basic financial statements are accompanied by required supplementary information. The AICPA has issued an interpretation to SSARS 19 (AR Section 9090, Review of Financial Statements: Accounting and Review Services Interpretations of Section 90) that addresses the accountant’s responsibilities for this information.

This interpretation states that the accountant is not required to apply procedures to any information presented for supplementary analysis purposes. This includes required supplementary information.

This interpretation describes how the accountant may modify the standard review report by including a separate paragraph that refers to the required supplementary information and explains the circumstances regarding its presentation. That paragraph follows the paragraph that reports the results of the engagement.

**Example explanatory paragraphs.** When the required supplementary information is included but not audited, reviewed, or compiled by the accountant, this paragraph reads the same as that shown above for compilations.

When all the required supplementary information is omitted, this paragraph reads the same as that shown above for compilations, with the addition of a final sentence that reads:

> The results of our review of the basic financial statements are not affected by this missing information.

This interpretation also provides example wording for use when some required supplementary information has been omitted and some is presented in accordance with prescribed guidelines.

**STUDY QUESTION**

6. When reviewed basic financial statements are accompanied by supplementary information, SSARS 19 requires that:

   a. The accountant review the supplementary information.
   b. The accountant clearly indicate in the review report the degree of responsibility, if any, taken with respect to the supplementary information.
   c. An explanation regarding the supplementary information must be included in the review report.
   d. When certain supplementary information is omitted, the review report should state that the results of the review of the basic financial statements are not affected by the missing information.
<table>
<thead>
<tr>
<th>Items That May Be Included in Other Information</th>
<th>Items That Are Excluded from Other Information</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reports on operations by management or those charged with governance</td>
<td>Press releases or similar memoranda or cover letters accompanying the audited financial statements and auditor's report</td>
</tr>
<tr>
<td>Financial summaries or highlights</td>
<td>Information contained in analyst briefings</td>
</tr>
<tr>
<td>Employment data</td>
<td>Information contained on the entity’s Web site</td>
</tr>
<tr>
<td>Planned capital expenditures</td>
<td></td>
</tr>
<tr>
<td>Financial ratios</td>
<td></td>
</tr>
<tr>
<td>Names of officers and directors</td>
<td></td>
</tr>
<tr>
<td>Selected quarterly data</td>
<td></td>
</tr>
</tbody>
</table>

Table 2: Identifying Supplementary Information—Some Common Examples

- Additional details or explanations of items in or related to the basic financial statements
- Consolidating information
- Historical summaries of items extracted from the basic financial statements
- Statistical data
- Other material, some of which may be from sources outside the accounting system or entity

Table 3: Identifying Required Supplementary Information—Some Common Examples

<table>
<thead>
<tr>
<th>Items Included in Required Supplementary Information</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FASB-Required:</strong></td>
</tr>
<tr>
<td>Supplementary oil and gas reserve information required under Accounting Standards Codification (ASC) section 932-Extractive Industries—Oil and Gas</td>
</tr>
<tr>
<td>Common Interest Realty Association replacement reserve schedule</td>
</tr>
<tr>
<td><strong>GASB-Required:</strong></td>
</tr>
<tr>
<td>Budgetary comparison schedules when not reported within the basic financial statements</td>
</tr>
<tr>
<td>Schedules of funding progress and employer contributions, for entities participating in sole or agent defined benefit pension plans</td>
</tr>
<tr>
<td>Asset condition schedules for governmental entities using the modified approach for infrastructure assets</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Items Not Included in Required Supplementary Information</th>
</tr>
</thead>
<tbody>
<tr>
<td>Schedule of Findings and Questioned Costs in an audit under OMB Circular A-133.</td>
</tr>
<tr>
<td>ERISA and DOL required schedules for employee benefit plans, such as:</td>
</tr>
<tr>
<td>- Assets held for investment purposes at the end of the year.</td>
</tr>
<tr>
<td>- Assets held for investment purposes that were both acquired and sold during the year.</td>
</tr>
<tr>
<td>- Nonexempt transactions, loans or fixed income obligations, or leases in default or classified as uncollectible.</td>
</tr>
<tr>
<td>- Reportable (five percent) transactions.</td>
</tr>
<tr>
<td>Schedules of costs of goods sold, or selling and general and administrative expenses.</td>
</tr>
<tr>
<td>Schedules of estimated repairs and replacements (reserve study data) for common interest realty associations.</td>
</tr>
<tr>
<td>Management discussion and analysis accompanying the financial statements.</td>
</tr>
</tbody>
</table>
LEARNING OBJECTIVES

Upon completion of this chapter, the reader should be able to:

- Recognize situations in which AU-C section 930, Interim Financial Information, is applicable
- Define characteristics of a review of interim financial information that distinguish it from engagements under other standards
- List analytical procedures and inquiries that are normally performed in connection with a review of interim financial statements
- Describe the requirements for reporting under various circumstances in a review of interim financial information

INTRODUCTION

AU-C section 930, Interim Financial Information, addresses the auditor’s responsibilities when engaged to review interim financial information under the conditions set forth in this standard. A review of interim financial information under this standard is a distinct service, apart from either an audit of financial statements under generally accepted auditing standards (GAAS) or a review conducted under the Statements of Standards on Accounting and Review Services (SSARS).

This course primarily addresses the applicability of this standard, including the characteristics and limitations of an engagement to review interim financial information, and its procedural and reporting requirements.

Applicability

This standard applies under the following conditions:

- The entity’s most recent annual financial statements have been audited by the auditor or by a predecessor auditor.
- The auditor has either:
  - Been engaged to audit the entity’s current year statements, or
  - Audited the latest annual financial statements, and in cases in which it is anticipated that the current year statements will be audited, another auditor has not been engaged to audit those statements prior to the beginning of the period covered by the review.
- The interim financial information is prepared using the same financial reporting framework as the annual financial statements.
All of the following conditions are met if the interim financial information is condensed:

- The condensed interim information purports to be prepared in accordance with an appropriate financial reporting framework which includes appropriate form and content of interim information.
- The condensed interim information contains a disclosure that it does not represent complete financial statements and is to be read in conjunction with the latest audited annual statements.
- The condensed interim information accompanies the latest audited financial statements, or those statements are made readily available without further action by the entity.

**Characteristics of a Review of Interim Financial Information**

The objective of an audit is to express an opinion on the financial statements. A review of interim financial information is far more limited in its objectives. It leads to a conclusion about whether the auditor is aware of any material modifications that should be made to the interim financial information in order for it to be in accordance with the applicable financial reporting framework, but not to an opinion.

A review consists principally of performing analytical procedures and inquiries and does not contemplate:

- Tests of accounting records through observation, inspection, or confirmation
- Tests of internal controls
- Obtaining corroborative evidence in response to inquiries
- Performing certain other procedures normally performed in an audit

The limitations of a review are that it does not:

- Provide a basis for expressing an opinion
- Provide reasonable assurance that the auditor will become aware of all significant findings or issues that an audit might identify
- Provide reasonable assurance about internal control or about identifying significant deficiencies or material weaknesses

**Effective Date**

This standard is effective for reviews of interim financial information for interim periods of fiscal years beginning on or after December 15, 2012.
STUDY QUESTION

1. AU-C section 930, *Interim Financial Information*, applies under all of the following conditions except:
   a. The most recent annual financial statements have been audited by a predecessor auditor.
   b. The auditor has been engaged to review the interim financial information in accordance with the *Statements of Standards on Accounting and Review Services*.
   c. The auditor has been engaged to audit the entity’s current year statements.
   d. The interim financial information and the annual financial statements have been prepared under the same financial reporting framework.

OBJECTIVE

The auditor’s objective under this standard is to obtain, by performing limited procedures, a basis for reporting whether the auditor is aware of any material modifications that should be made to the interim financial information for it to be in accordance with the applicable financial reporting framework.

DEFINITION

*Interim financial information* is defined as financial information prepared and presented in accordance with an applicable financial reporting framework that comprises either a complete or a condensed set of financial statements covering a period or periods less than a full year, or covering a 12-month period ending on a date other than the entity’s fiscal year end.

REQUIREMENTS

This standard sets forth presumptively mandatory requirements for reporting on compliance. These requirements are signaled in the Standards by the word “should.” Auditors are required to satisfy presumptively mandatory requirements except in rare circumstances when they document a justification for the departure, such as that it is not effective or economical to apply the requirement, and can demonstrate that other procedures satisfy its intent. This standard contains no unconditional requirements.

Acceptance

Before accepting an engagement under this standard for a new client, auditors should follow the same procedures required for initial engagements required by AU-C section 210, *Terms of Engagement*.

Before accepting an engagement under this standard, auditors should:
Determine the acceptability of the financial reporting framework to be used.

Obtain management’s agreement that it acknowledges and understands its responsibilities:
- For the preparation and presentation of the interim financial information
- For the design, implementation, and maintenance of internal control
- To provide the auditor with:
  - Access to all relevant information that management is aware of, such as records, documentation, and other matters
  - Additional information requested by the auditor
  - Unrestricted access to persons within the entity of whom the auditor determines it necessary to make inquiries
- To include the auditor’s review report in any document containing the interim financial information that indicates it has been reviewed by the auditor.

Auditors should not accept engagements under this standard if:
- They have determined the financial reporting framework is not acceptable.
- Management does not agree to its responsibilities as outlined in the preceding paragraph.

Auditors should agree with management or with those charged with governance, as appropriate, on the terms of the engagement. That agreement should be in writing, and should include:
- The objectives and scope of the engagement
- Management’s responsibilities, as set forth above
- The auditor’s responsibilities
- The limitations of the review engagement
- Identification of the applicable financial reporting framework

**STUDY QUESTION**

2. All of the following statements apply to the auditor’s process for accepting an engagement under this standard **except**:

   a. Auditors should not accept engagements under this standard if management does not agree to provide the auditor with access to all relevant information that it is aware of.
   b. The agreement to provide services under this standard should be in writing.
   c. Determining the acceptability of the financial reporting framework to be used is management’s sole responsibility.
   d. The agreement to provide services under this standard should include the limitations of the review engagement.
Procedures for Review of Interim Financial Information

This section sets forth the requirements for understanding the entity and its environment, including its internal control, and for the analytical procedures, inquiries, and other review procedures to be performed.

Understanding the entity and its environment, including internal control. To plan and conduct the engagement, auditors should have an understanding of the entity and its environment. This includes its internal controls relating to the preparation and fair presentation of annual and interim financial information. That understanding should enable the auditor to:

- Identify potential types of misstatements in the interim financial information
- Consider the likelihood of their occurrence
- Select inquiry and analytical procedures that will provide a basis for reporting whether the auditor is aware of any material modifications that should be made in order for the interim financial information to be in accordance with the applicable financial reporting framework

In order to obtain or update this understanding, auditors should:

- Read available documentation of the prior year’s audit, reviews of prior interim periods in the current year, and the corresponding interim period of the prior year to identify matters that may affect the current interim period, including:
  - Corrected and uncorrected misstatements
  - Risks of material misstatement due to fraud, including the risk of management override of controls
  - Financial accounting and reporting matters such as significant deficiencies or material weaknesses in internal control that may have ongoing importance
- Read the most recent annual and comparable prior period interim financial information
- Consider the results of any audit procedures performed on the current year’s financial statements
- Inquire of management about:
  - Changes in business activities
  - Related party transactions
  - Significant changes in internal control, including changes in policies, procedures, and personnel

Analytical procedures. Auditors should apply analytical procedures designed to provide a basis for inquiry about unusual relationships and individual items that may indicate material misstatements. These procedures are not
unlike many that might be applied either as part of an audit of the financial statements, or in a review engagement under SSARS. They should include:
- Comparing interim financial information with comparable information for the immediately preceding interim period, if applicable, and with corresponding prior year periods, considering knowledge about changes in the business and specific transactions
- Considering plausible relationships among financial and, where relevant, nonfinancial data
- Comparing recorded amounts or ratios calculated from them to the auditor’s expectations
- Comparing disaggregated revenue data, such as monthly or product-line information

Appendix A to this standard contains detailed discussion of seven specific analytical procedures that auditors may consider performing.

**STUDY QUESTION**

<table>
<thead>
<tr>
<th>3.</th>
<th>This standard lists which of the following as an analytical procedure that auditors should perform in a review of interim financial information?</th>
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</thead>
<tbody>
<tr>
<td>a.</td>
<td>Comparing interim financial information with comparable information for the immediately preceding interim period</td>
</tr>
<tr>
<td>b.</td>
<td>Calculating relevant nonfinancial data</td>
</tr>
<tr>
<td>c.</td>
<td>Comparing disaggregated expense data, such as monthly or by product line</td>
</tr>
<tr>
<td>d.</td>
<td>Vouching significant revenue transactions</td>
</tr>
</tbody>
</table>

**Inquiries and other review procedures.** Auditors should make inquiries and perform other review procedures as follows:
- Read meeting minutes, or summaries of meetings for which minutes have not been prepared, to identify matters that may affect the interim financial information
- Obtain reports from component auditors related to review of interim financial information of components of the entity, or inquire of the auditors if reports have not been issued
- Inquire of management about:
  - Whether the interim financial information is prepared and fairly presented in accordance with the applicable financial reporting framework consistently applied
  - Complex or unusual situations may affect the interim information. Appendix B to this standard contains detailed examples of such situations.
  - Significant transactions occurring or recognized in the interim period, particularly in the last days of the period
- The status of uncorrected misstatements identified in the previous audit and interim review
- Matters that have caused questions to arise in the course of the current interim review
- Subsequent events
- Knowledge of fraud or suspected fraud involving management or key employees
- Allegations of fraud or suspected fraud communicated by employees, former employees, regulators, or others
- Significant journal entries and other adjustments
- Communications from regulators
- Significant deficiencies or material weaknesses in internal control relating to preparation and fair presentation of annual or interim financial information
- Changes in related parties or significant new related party transactions
- Obtain evidence that the interim information agrees or reconciles with the accounting records, including an inquiry about the reliability of those records
- Read interim financial information to consider whether it is in accordance with the applicable financial reporting framework
- Read other information in documents containing the interim financial information to consider whether it, or the manner of its presentation, is materially inconsistent with the interim financial information. If material inconsistencies or material misstatements of fact exist, auditors should take action based on their professional judgment
- Inquire of the client’s legal counsel if information regarding litigation, claims, or assessments arises that leads the auditor question whether the interim financial information is materially misstated
- If substantial doubt about going concern matters arise, the auditor should:
  - Inquire about management’s plans for dealing with the adverse conditions or events
  - Consider the adequacy of disclosure in the interim financial information
- Consider the reasonableness and consistency of management’s responses in light of the results of other review procedures and the auditor’s knowledge. Auditors are not, however, required to corroborate management’s responses with other evidence.
- Make additional inquiries or perform additional procedures when a matter arises that causes the auditor to question whether the interim financial
information has been prepared in accordance with the applicable financial reporting framework in all material respects

**STUDY QUESTION**

4. The auditor’s inquiries and other procedures in a review of interim financial information ordinarily include all of the following *except*:

   a. Obtaining corroborative evidence to support management’s responses to inquiries.
   b. Reading minutes to identify matters that may affect the interim financial information.
   c. Reading interim financial information to consider whether it is in accordance with the applicable financial reporting framework.
   d. Inquiring about subsequent events.

**Evaluating the Results of Interim Review Procedures**

In evaluating the results of interim review procedures, auditors should:

- Accumulate the misstatements, including inadequate disclosures, identified during the review.
- Evaluate individually and in the aggregate those misstatements to determine whether material modification to the interim financial information is necessary in order for it to be in accordance with the applicable financial reporting framework.

**Written Representations from Management**

Auditors should request written representations from management for all periods covered by the review, as of the date of the auditor’s review report. Auditors should take appropriate action when they have concerns about the reliability of the representations. If management does not provide all of the required representations, the auditor should withdraw from the engagement.

This section sets forth specific, detailed representations that are required. Exhibit A to this standard provides illustrations of both “short form” and “detailed” representation letters.

**Communications with Management and Those Charged with Governance**

This section addresses difficulties that may occur in an engagement under this standard, and the auditor’s responses to and communication responsibilities for them.

**Matters affecting review completion.** If unable to complete the review, the auditor should communicate to the appropriate level of management and those charged with governance:
The reasons why the review cannot be completed
That a review report cannot be issued because an incomplete review does not provide a basis for reporting
Any material modifications that should be made to the interim financial information

Auditors should communicate to the appropriate level of management as soon as practicable matters that cause them to believe that:
- Material modification should be made to the interim financial information
- The entity issued the interim financial information prior to the completion of the review

If management does not, in the auditor’s judgment, respond appropriately to auditor communications within a reasonable time, the auditor should inform those charged with governance as soon as practicable.

If those charged with governance do not respond to auditor communications in an appropriate and timely manner, the auditor should consider whether to withdraw from:
- The review engagement
- Serving as the entity’s auditor, if applicable

**Other matters.** If auditors become aware that fraud or noncompliance with laws or regulations may have occurred, they should:
- Communicate the matter to the appropriate level of management as soon as practicable
- If the fraud involves senior management or results in material misstatement of the interim financial information, communicate the matter directly to those charged with governance
- If the matter involves other than clearly inconsequential noncompliance with laws or regulations, communicate to those charged with governance

In addition, auditors should communicate to those charged with governance:
- Significant deficiencies and material weaknesses in internal control
- Other matters that would ordinarily be communicated in an audit of financial statements under GAAS, insofar as they pertain to the interim financial information
STUDY QUESTION

5. In a review of interim financial information, the auditor’s communication with those charged with governance includes all of the following except:
   a. All detected instances of noncompliance with laws or regulations
   b. Matters pertaining to the interim financial information that would ordinarily be communicated in an audit of financial statements under GAAS
   c. Material weaknesses in internal control
   d. Fraud involving senior management

Auditor’s Report

This section addresses the form of the standard auditor’s review report and several variations thereon. Exhibit B to this standard contains illustrative wording for review reports:

- On Interim Financial Information
- On Condensed Comparative Interim Financial Information
- That Refer to a Component Auditor’s Review Report on the Interim Financial Information of a Significant Component of a Reporting Entity
- On Comparative Interim Financial Information When the Prior Period Was Reviewed by Another Auditor

Standard form of the report. The auditor’s review report should be written and should contain the following elements:

- A title including the word “independent”
- An addressee
- An introductory paragraph that:
  - Identifies the entity
  - States that the interim financial information identified was reviewed
  - Identifies that information
  - Specifies the date or period covered by each financial statement included in the interim financial information
- A section bearing the heading “Management’s Responsibility” that includes a detailed explanation of certain specific responsibilities of management
- A section bearing the heading “Auditor’s Responsibility” that includes the following statements:
  - The auditor’s responsibility is to conduct the review in accordance with U.S. GAAS applicable to reviews of interim financial information
  - A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters
  - A review of interim financial information is substantially less in scope than an audit conducted in accordance with U.S. GAAS, the
objective of which is to express an opinion regarding the financial information as a whole. Accordingly, no such opinion is expressed

- A concluding section with an appropriate heading that includes a statement about whether the auditor is aware of any material modifications that should be made to the interim financial information for it to in accordance with the applicable financial reporting framework, and that identifies, if applicable, the country of origin of those accounting principles
- The audit firm’s manual or printed signature
- The audit firm’s city and state
- The date of the review report, which should be the date of the completion of the review procedures

The auditor should also determine that the client has clearly marked as “unaudited” each page of the interim financial information that accompanies the auditor’s review report.

**Variations on the standard report.** This section addresses several common circumstances that call for variations on the standard report.

*Comparative information not reviewed.* When current period interim financial information that the auditor has reviewed is presented in comparative form with interim information of a prior period that has not been reviewed, the auditor’s review report should indicate that:

- The prior period information has not been reviewed.
- The auditor assumes no responsibility for the prior period information.

*Interim financial information presented with condensed balance sheet.* When a condensed balance sheet derived from audited statements is presented on a comparative basis with the interim financial information, auditors should report on that condensed balance sheet only when they have audited the related financial statements. Auditors should compare the condensed balance sheet with the related information in the audited statements to determine if it agrees with or can be recalculated from that information.

The auditor’s report on the interim information should address the condensed balance sheet in a paragraph that:

- Identifies the condensed balance sheet
- Identifies the audited financial statements from which it was derived
- Indicates that those financial statements are not separately presented
- Refers to the auditor’s report on those statements, including:
  - Its date
  - The type of opinion expressed
  - The basis for a modified opinion, if applicable
- A description of the nature of any emphasis-of-matter or other-matter paragraphs included in that report
- Includes an opinion about whether the condensed balance sheet is consistent in all material respects with the audited statements from which it was derived

*Modifications of the report.* When the interim financial information is not prepared in accordance with the applicable financial framework in all material respects, auditors should:
- Consider whether modification of the review report is sufficient to address the departure
- If modification of the report is sufficient, the modified report should contain:
  - A description of the departure
  - If practicable, the effects of the departure
  - If the departure is due to inadequate disclosure, information that the auditor believes necessary for adequate disclosure, when practicable
- If modification of the report is not sufficient, the auditor should:
  - Withdraw from the engagement
  - Provide no further services with respect to the interim financial information

### STUDY QUESTION

<table>
<thead>
<tr>
<th>6. Which of the following statements best applies to the auditor’s reporting responsibilities under this standard?</th>
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<tbody>
<tr>
<td>a. If the auditor’s report is modified for a material departure from the applicable financial reporting framework, the report must state the effects of the departure.</td>
</tr>
<tr>
<td>b. The auditor should determine that each page of the interim financial information that accompanies the auditor’s review report is clearly marked as “unaudited.”</td>
</tr>
<tr>
<td>c. If the interim financial information is not prepared in accordance with the applicable financial framework in all material respects, the auditor should withdraw from the engagement.</td>
</tr>
<tr>
<td>d. When current period interim financial information that the auditor has reviewed is presented in comparative form with interim information of a prior period that has not been reviewed, the auditor’s review report should indicate the degree of responsibility that the auditor is taking for the prior period information.</td>
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</tbody>
</table>
Subsequent Discovery of Facts
This section refers auditors to AU-C section 560, *Subsequent Events and Subsequently Discovered Facts*, for actions to take if, subsequent to the date of the auditor’s review report, facts are discovered that existed at the date of the review report that might have affected the auditor’s review report.

Other Considerations
This section addresses the auditor’s actions when management does not include the auditor’s review report in a document, report, or written communication containing the reviewed interim financial information that indicates it has been reviewed by the auditor. In this case, the auditor should:
- Request management to amend the document, report, or written communication to include the review report, and reissue it
- If management does not comply, request that the auditor’s name not be associated with that interim information
- Communicate management’s noncompliance to those charged with governance
- Recommend that the client consult legal counsel when appropriate
- Consider what other actions might be appropriate

If the auditor issued a modified report due to a departure from the applicable financial reporting framework, but management issues the interim financial information without that report, the auditor should determine the appropriate course of action, including whether to withdraw from the engagement to audit the annual financial statements.

Interim Financial Information Accompanying Audited Statements
Auditors should include an other-matter paragraph in the auditor’s report on the audited financial statements when all of the following conditions are present:
- The interim financial information has been reviewed in accordance with this standard and is included in a document containing audited financial statements.
- The interim financial information accompanying the audited statements does not appear to be in conformity with the applicable financial reporting framework.
- The auditor’s separate review report referring to the departure is not presented with the interim financial information.

When interim financial information that is presented as a note to the financial statements, including information that has been reviewed in accordance with this standard, is not appropriately marked as unaudited, the auditor should disclaim an opinion on that information in the audit report on the financial statements.
Documentation
Auditors should prepare documentation for engagements conducted under this standard that will enable an experienced auditor having no previous connection to the engagement to understand:
- The nature, timing, and extent of review procedures performed
- The results of those procedures
- The evidence obtained
- Significant findings or issues
- Conclusions reached on those issues
- Significant professional judgments made in reaching those conclusions

The review engagement documentation should contain all of the communications required in this standard, whether written or oral. The auditor’s communication with those charged with governance, for example, may be oral. However, that oral communication should be documented.

CPE NOTE: When you have completed your study and review of chapters 8–10, which comprise Module 3, you may wish to take the Quizzer for this Module.

Go to CCHGroup.com/PrintCPE to take this Quizzer online.
Reporting on Compliance with Contractual Agreements or Regulatory Requirements

LEARNING OBJECTIVES

Upon completion of this chapter, the reader should be able to:

- Identify the circumstances in which this Standard applies and distinguish them from circumstances in which it does not apply
- List the attributes of a compliance report
- Explain the implications for the compliance report of the auditor’s report on the financial statements
- Recognize the alternative forms of compliance reports

INTRODUCTION

Reporting on Compliance With Aspects of Contractual Agreements or Regulatory Requirements in Connection With Audited Financial Statements addresses the auditor’s responsibilities when requested to report on an entity’s compliance with aspects of contractual agreements or regulatory requirements related to accounting matters, in connection with an audit of financial statements.

Entities may be required by contractual agreements or regulatory agencies to provide an auditor’s report on compliance. A lender may, for example, request the auditor to report on a borrower’s compliance with certain covenants of the loan agreement relating to accounting matters. An auditor can satisfy this request by issuing a report on compliance under this standard.

Applicability

This standard applies only to reporting on compliance with aspects of contractual agreements or regulatory requirements as a by-product of an audit on the financial statements. It does not apply when the auditor is:

- Engaged or required by law or regulation to perform a compliance audit in accordance with generally accepted auditing standards (GAAS) and the standards for financial audits under Government Auditing Standards (GAGAS), and there is a governmental requirement that the auditor express an opinion on compliance with applicable compliance requirements. In this case, SAS 117, Compliance Audits, applies.
- Engaged to perform a separate attest engagement on:
TOP AUDITING ISSUES FOR 2013 CPE COURSE

The entity’s compliance with the requirements of specific laws, regulations, rules, contracts or grants
- The effectiveness of an entity’s internal control over compliance with specified requirements

In this case, AT section 601, Compliance Attestation, applies.

Effective Date
This standard is effective for reports on compliance issued in connection with audited financial statements for periods ending on or after December 15, 2012.

STUDY QUESTION

1. This standard applies only when the auditor is engaged to:
   a. Perform a separate attest engagement on the entity’s compliance with the requirements of specific laws, rules or regulations
   b. Report on compliance with aspects of contractual agreements or regulatory requirements as a by-product of a financial statement audit
   c. Report on compliance with contractual or regulatory requirements for purposes of a judicial proceeding
   d. Perform a compliance audit in accordance with GAAS and Government Auditing Standards when there is a governmental requirement that the auditor express an opinion on compliance

OBJECTIVE
The auditor’s objective is to report appropriately on compliance with aspects of contractual agreements or regulatory requirements in connection with audited financial statements, when requested to do so.

REQUIREMENTS
This standard sets forth presumptively mandatory requirements for reporting on compliance. These requirements are signaled in the Standards by the word “should.” It contains no unconditional requirements.

General Reporting Requirements
The compliance report should contain a statement that nothing came to the auditor’s attention that caused the auditor to believe that the entity failed to comply with aspects of contracts or regulations only under the following conditions:
■ No instances of noncompliance have been identified.
■ The auditor has expressed an unmodified or qualified opinion on the related financial statements.
■ The applicable covenants or regulatory requirements relate to accounting matters that have been audited in the financial statement audit.

When one or more instances of noncompliance are identified, the compliance report should describe them.

When the auditor has disclaimed or expressed an adverse opinion on the financial statements, the auditor should issue a report only when noncompliance has been identified. The compliance report should describe the noncompliance.

The auditor is not precluded from issuing a report on compliance if required by another body of auditing standards, such as GAGAS, and the auditor has been engaged to audit the financial statements under both those standards and GAAS.

The report should be written. The report should appear either in:
■ A separate report, or
■ One or more paragraphs included in the auditor’s report on the financial statements.

STUDY QUESTION

2. All of the following preclude an auditor from issuing a compliance report that identifies no instances of noncompliance except:
   a. The covenants or regulatory requirements relating to accounting matters have not been audited in the financial statement audit.
   b. The auditor issued a qualified opinion on the financial statements.
   c. The auditor has not been engaged to audit the financial statements under GAAS.
   d. The entity requests a compliance report to be combined with the auditor’s report on the financial statements.

Separate Reports

When the auditor reports separately on compliance, that report should contain:
■ A title including the word “independent”
■ An appropriate addressee
■ A paragraph stating that the financial statements were audited in accordance with U.S. GAAS, and the date of the auditor’s report on those statements
■ A statement describing the nature of modifications, if any, to the standard auditor’s opinion on the financial statements
A reference to the specific covenants or paragraphs of the contract or regulation and a statement that nothing came to the auditor’s attention that caused the auditor to believe that the entity failed to comply specified aspects of the contractual agreements or regulatory requirements, insofar as they relate to accounting matters, when no instances of noncompliance are identified.

When the auditor detects instances of noncompliance, a reference to the specific covenants or paragraphs of the contract or regulation insofar as they relate to accounting matters, and a description of the noncompliance.

A statement that the report is being provided in connection with the audit of the financial statements.

A statement that the audit was not directed primarily toward obtaining knowledge regarding compliance, and accordingly, had the auditor performed additional procedures, other matters may have come to the auditor’s attention regarding noncompliance with specific covenants or paragraphs of the contract or regulation, insofar as they relate to accounting matters.

A paragraph that includes the source and description of management’s significant interpretations, if any, of the contractual or regulatory requirements.

A paragraph that includes an appropriate alert restricting the use of the report.

The auditor’s manual or printed signature.

The city and state in which the auditor practices.

The report date, which should match the date of the auditor’s report on the financial statements.

**Observation**

A separate compliance report may also communicate certain other matters contained in the auditor’s report on the financial statements that are modifications to the auditor’s opinion. For example, if the report on the financial statements contains an emphasis-of-matter paragraph for a going concern issue, this may also be included in the separate compliance report.

**Combined Reports**

When the compliance report is combined with the auditor’s report on the financial statements, that report should include:

- An “other-matters” paragraph that contains a reference to the specific covenants or paragraphs of the contract or regulation insofar as they relate to accounting matters.

- A statement that nothing came to the auditor’s attention that caused the auditor to believe that the entity failed to comply with specified aspects of
the contractual agreements or regulatory requirements, insofar as they relate to accounting matters, when no instances of noncompliance are identified

■ When the auditor detects instances of noncompliance, a description of that noncompliance
■ A statement that the report is being provided in connection with the audit of the financial statements
■ A statement that the audit was not directed primarily toward obtaining knowledge regarding compliance, and accordingly, had the auditor performed additional procedures, other matters may have come to the auditor’s attention regarding noncompliance with specific covenants or paragraphs of the contract or regulation, insofar as they relate to accounting matters
■ A paragraph that includes the source and description of management’s significant interpretations, if any, of the contractual or regulatory requirements
■ A paragraph that includes an appropriate alert restricting the use of the portion of the report that pertains to compliance

OBSERVATION

Entities may sometimes be granted waivers for noncompliance. Auditors may, in such cases, include in either a separate or combined report a statement that a waiver has been obtained. The decision to do this is based on the procedures performed to evaluate the waiver in connection with the financial statement audit. All identified instances of noncompliance are required to be reported, regardless of whether a waiver has been obtained.

STUDY QUESTION

3. Which of the following statements best applies to the auditor’s reporting responsibility when instances of noncompliance are identified?

   a. Instances of noncompliance need not be reported when a waiver has been obtained.
   b. Immaterial instances of noncompliance should not be reported.
   c. All identified instances of noncompliance should be reported.
   d. All identified instances of noncompliance are required to be reported along with references to the specific covenants or paragraphs of the contract or regulation.

EXHIBITS

The exhibits to this standard contain the following illustrative compliance reports:

■ Separate report—no instances of noncompliance identified
■ Separate report—instances of noncompliance identified
Separate report—instances of noncompliance identified and waiver obtained
Separate report—instances of noncompliance identified and the auditor has disclaimed an opinion on the financial statements
Combined report—no instances of noncompliance identified
INTRODUCTION

The American Institute of Certified Public Accountants (AICPA) Clarity Project has been underway since 2004. It has reached near-completion and the implementation of a new Codification of Statements on Auditing Standards (Clarified) is imminent.

The previously existing 68 AU sections have been condensed into 47 sections in the new Codification. Most of them are fairly consistent with existing GAAS. Some, however, contain significant changes. The redrafted standards are said to be more “principles-based” and less “rules-based” than the previous standards.

Most practitioners will find the clarity format much easier to use because it introduces a uniform format for all the standards, and segregates all of the definitions and requirements into distinct sections, which are always in the same place within each standard. The previous format contained definitions and requirements interspersed throughout each pronouncement. This made them hard to find and at times left room for doubt, or at least for confusion, as to what was and was not a requirement.

This course provides an overview of the organization and structure of the new Codification, highlights significant changes from previous practice, and discusses possible approaches to practical issues that many firms will likely face in implementation.

Effective Date

The clarified standards are generally effective for audits of financial statements for periods ending on or after December 15, 2012. Early implementation is
not permitted. This means that, for most users, calendar year 2012 audits will be the year of implementation.

INTERNATIONAL CONVERGENCE

The clarified standards have been developed with a view toward converging them with the International Standards on Auditing (ISAs) promulgated by the International Auditing and Assurance Standards Board (IAASB). It is important to note that this does not signal a wholesale adoption of the ISAs. Rather, it means that unnecessary differences between the SASs and the ISAs have been eliminated where possible.

Applicable ISAs were used as a base for drafting each clarified SAS. The most noticeable changes are:
- The new Codification has a different numbering system, which parallels that of the ISAs.
- Each standard is organized under a uniform outline.

An appendix to the new Codification lists all the substantive differences in objectives between a clarified standard and the equivalent ISA.

THE NEW CLARITY FORMAT

The new format reorganizes all standards into a uniform format, similar to that of the ISAs, with these sections:

Introduction. This section explains the purpose and scope of the standard.

Objective. This section defines the context in which the requirements are set.

Definitions. This section explains the meaning of specific terms used in the standard, where applicable.

Requirements. This section sets forth what the auditor is required to do to meet the objectives of the standard. Requirements are expressed using two words: “must” and “should.” The word “must” indicates an unconditional requirement that the auditor is required to satisfy in all circumstances in which it is applicable. The word “should” indicates a presumptively mandatory requirement. The auditor is required to satisfy presumptively mandatory requirements except in rare circumstances when the auditor documents a justification for the departure, such as that it is not effective or economical to apply the requirement, and can demonstrate that other procedures satisfy its intent.

Application and Other Explanatory Material. This section contains paragraphs which are cross-referenced to the related requirements. They
provide additional guidance and explanation for carrying out the requirements of the standard. The “Application and Other Explanatory Material” section is an integral part of each standard. Even though this section contains no requirements, auditors should read and understand the entire text of this section, and should be prepared to justify departures from it in their work.

Exhibits. Exhibits are interpretive publications, not auditing standards. They are recommendations on the application of auditing standards in particular circumstances or for specialized industries. Auditors are required to consider applicable interpretive publications in planning and performing an audit.

Special considerations. Where appropriate, the clarified standards contain special considerations that apply to smaller, less complex entities and to governmental entities.

ORGANIZATION AND HIGHLIGHTS OF THE NEW CODIFICATION

The following section discusses the layout of the new Codification. It also highlights some of the changes from previous standards that are likely to create practical issues in transitioning between the two sets of standards.

Numbering

The sections in the initial issuance of the new Codification are numbered with AU-C numbers, instead of the old AU numbers. This is a temporary identifier, to avoid confusion with references to the extant AU sections, which remain effective through 2013. The AU-C identifier will revert to AU in 2014, by which time the sections’ content will be fully effective for all engagements.

Paragraphs within each AU-C section are decimally numbered, and are referenced, where applicable, to any related paragraphs in the Application and Other Explanatory Material section. In order to clearly distinguish them from the other portions of an AU-C section, paragraphs in the Application and Other Explanatory Material are designated by the letter A followed by a number. These paragraphs are referenced back to the paragraphs in the main body of the section to which they apply.

Auditing Interpretations are codified with a 9000-series number following immediately after the related AU-C section. For example, the auditing interpretation entitled Audit Documentation: Auditing Interpretations of Section 230 is numbered as AU-C Section 9230, and follows directly after AU-C Section 230, Audit Documentation, in the new Codification.

The numbering scheme for the AU-C sections roughly corresponds to the chronology of a typical audit engagement. General principles, for example, are numbered in the 200 series. Risk assessment and responses to assessed
risks, which come early in an audit, are numbered in the 300 and 400 series. Reporting, which comes later, appears in the 700 series.

STUDY QUESTION

1. All of the following numbering conventions apply to the new Codification except:
   a. Auditing Interpretations are codified with a 9000-series number.
   b. The sections in the new Codification are permanently designated with AU-C numbers.
   c. Application and Other Explanatory Material paragraphs are designated by the letter A followed by a number.
   d. The numbering sequence for the AU-C sections roughly follows the chronology of a typical audit engagement.

Preface

The new Codification contains a two-page preface entitled Principles Underlying an Audit Conducted in Accordance With Generally Accepted Auditing Standards. This preface is important because it sets forth broad philosophical principles underlying an audit conducted in accordance with generally accepted auditing standards (GAAS).

These principles provide a framework that is useful in understanding and explaining an audit. They are organized to provide a structure for the new codification of auditing standards. This structure addresses:
- The purpose of an audit
- The personal responsibilities of the auditor
- Auditor actions in performing the audit
- Reporting

These principles are not requirements and do not carry any authority.

Glossary

The new Codification contains a master glossary that defines nearly 300 terms that are used throughout GAAS and the Statements on Quality Control Standards. This is an improvement over the previous codification, in which there was no master glossary or other central source for finding the meaning of a specific term.

General Principles and Responsibilities (AU-C Sections 200–299)

The following AU-C sections will be of interest to all firms, and may present significant transitional issues for many firms:

200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards. This section
contains conceptual principles that shape the overall objectives of an audit, and broad, overarching requirements that govern an audit’s conduct. It is intended to be the initiating or originating document for the new *Codification*. If a practitioner or a student of auditing were to read only one new standard cover-to-cover, this should be the one. Reading this standard will re-orient established practitioners to the changed landscape of the auditing literature. Academicians, students, and young or beginning practitioners should also give this standard the most careful study because it will provide them with a conceptual foundation and help them to place the rest of the auditing literature into a broader context.

This standard forms the starting point for the new *Codification*. It sets forth concepts, definitions, and requirements, and establishes the organizational structure that is pervasive to the rest of GAAS. It addresses the overall responsibilities of the independent auditor when conducting an audit of financial statements in accordance with GAAS, sets forth the auditor’s overall objectives, and explains both the nature and scope of an audit designed to meet the auditor’s overall objectives, and the scope, authority, and structure of GAAS. This standard also includes requirements that establish the auditor’s general responsibilities applicable to all audits.

**250 Consideration of Laws and Regulations in an Audit of Financial Statements.** This section requires auditors to perform procedures to identify instances of noncompliance with laws and regulations that may materially affect the financial statements. Previous standards did not require auditors to perform any procedures unless specific information came to their attention concerning possible illegal acts. Under this section, auditors are required to:

- Inspect correspondence, if any, with relevant licensing or regulatory authorities
- Obtain an understanding of the legal and regulatory framework
- Obtain an understanding of how the entity is complying with that framework
- Determine whether the auditor has a responsibility to report suspected noncompliance to outside parties
- Document identified or suspected noncompliance, including the results of any discussions about such items

**265 Communicating Internal Control Matters Identified in an Audit.** This section adds requirements for the auditor to:

- Include in the written communication an explanation of the potential effects of the significant deficiencies and material weaknesses identified. The guidance material included in this section, however, states that the effects need not be quantified.
Communicate to only management, orally or in writing, other deficiencies in internal control identified in the audit that have not been communicated to management by other parties and that are, in the auditor’s professional judgment, sufficiently important to merit management’s attention.

Risk Assessment and Response to Assessed Risks (AU-C Sections 300–499)
The clarified standards do not change or expand previous standards in this area in any significant way.

Audit Evidence (AU-C Sections 500–599)
The following sections contain substantive changes that may present transitional issues.

501 Audit Evidence—Specific Considerations for Selected Items. This section takes a more principles-based approach to determining whether to seek direct communication with the entity’s attorneys.
- Direct communication through a letter of inquiry is required only when the auditor assesses a risk of material misstatement concerning litigation or claims, or when audit procedures indicate that material litigation or claims may exist.
- Auditors are required to document the basis for a decision not to seek direct communication with legal counsel.

510 Opening Balances. The clarified standard makes it explicit that reviewing a predecessor’s audit documentation cannot be the only procedure performed to obtain sufficient appropriate evidence regarding opening balances in initial audits. This is a significant departure from previous practice.

The auditor’s objectives, according to the new standard, are to obtain sufficient appropriate evidence about whether:
- Opening balances contain misstatements that materially affect the current period’s financial statements
- Accounting policies reflected in the opening balances have been consistently applied in the current period’s financial statements
- Changes in accounting policies have been properly accounted for, adequately presented, and disclosed in accordance with the applicable financial reporting framework

Procedures to address these objectives include:
- Determining whether prior period closing balances are brought forward correctly
- Determining whether opening balances reflect appropriate application of accounting policies
- Evaluating whether current period audit procedures provide evidence
about opening balances by means of performing one or both of the following:
- Performing specific procedures related to opening balances
- Reviewing predecessor auditor’s work

Review of the predecessor’s work may provide evidence about opening balances and consistent application of accounting principles. But the nature, timing, and extent of audit work performed and conclusions reached on the current period audit are the sole responsibility of the current auditor. The auditor’s determination of whether to rely on evidence obtained as a result of reviewing the predecessor auditor’s work is influenced by the auditor’s assessment of the predecessor’s professional competence and independence.

550 Related Parties. The new standard is neutral as to the financial reporting framework, and is applicable whether or not that framework establishes requirements for related party disclosures.

Using the Work of Others (AU-C Sections 600–699)

600 Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors). This clarified standard is significantly broader in scope than the previous standard. It focuses on how to conduct an effective audit of group financial statements, rather than on how to conduct an audit that involves other auditors. In particular, it better articulates the link between the risk assessment standards and group financial statement audits. Its requirements address:
- Acceptance and continuance considerations
- The group engagement team’s risk assessment process, including:
  - Obtaining an understanding of the group, components, and group-wide controls
  - Obtaining an understanding of the consolidation process
- Determination of materiality to be used in the group financial statement audit
- Determination of materiality to be used in the audits of components
- Selection of components and account balances for testing
- Communication between the group engagement team and component auditors
- Assessing the adequacy and appropriateness of audit evidence by the group engagement team in forming its opinion

This section permits the auditor of the group financial statements to refer to a component auditor in the report on the audit of the group financial statements if all of the following preconditions are met:
- Component financial statements are prepared using the same financial reporting framework
- Component auditor followed GAAS
- Component auditor’s report is not restricted as to use

Group auditors who decide not to make reference to a component auditor’s report, and thus take responsibility for the work of the component auditor, are taking on a larger responsibility compared to previous standards

STUDY QUESTION

2. All of the following are significant changes to previous auditing standards that will take effect with the new Codification except:

   a. The clarified standard on audits of group financial statements is significantly broader in scope than the previous standard.

   b. The clarified standard on related parties is applicable only when the entity’s financial reporting framework establishes requirements for related party disclosures.

   c. The clarified standard on opening balances states that reviewing a predecessor’s audit documentation cannot be the only procedure performed to obtain sufficient appropriate evidence regarding opening balances in initial audits.

   d. The clarified standard on communicating internal control matters requires auditors to include in their written communication an explanation of the potential effects of the significant deficiencies and material weaknesses identified.

OBSERVATION

As this course entered production, the AICPA released an exposure draft of proposed amendments to AU-C section 600. Those amendments would, if they became effective, make the following changes:

- Permit making reference to the component auditor’s work in the audit report on the group financial statements, when the component’s statements are prepared using a different financial reporting framework, if certain criteria are met

- Require that the auditor’s report on the group financial statements disclose that the auditor of the group financial statements audited the conversion adjustments, when reference is made to a component auditor’s report

- Require that when the group engagement partner decides to refer to the report of a component auditor and has determined that the component auditor performed additional audit procedures to comply with GAAS, the group audit report clearly indicate that the group auditor is relying both on the component auditor’s report and the additional procedures

Readers of this course should stay abreast of developments on this matter by referring to the AICPA’s Web site and to CCH’s Accounting Research Manager at www.accountingresearchmanager.com.
Audit Conclusions and Reporting (AU-C Sections 700–799)

These sections introduce significant changes to previous reporting practices and requirements that will affect all firms.

700 Forming an Opinion and Reporting on Financial Statements. The form of the new audit report is greatly different from the familiar report under previous standards. It contains significantly expanded discussion of the auditor's responsibility as contrasted with management's. There are paragraph headings for:
- Management's responsibility for the financial statements
- The auditor's responsibility
- The auditor's opinion

The paragraph covering management's responsibility is standardized language. It is important to note that the new standard prohibits any elaboration in the auditor's report about management's responsibility, or any reference to another document that does so. This might lead users of the report to the erroneous conclusion that the auditor is expressing assurances about any representations made by management about its responsibilities.

When the auditor's report also covers other legal or regulatory requirements, it contains headings that separate the report on the financial statements from the report on the other requirements.

**Observation**

If the reception by the profession of the reporting requirements of Statement of Standards on Accounting and Review Services No. 19 (SSARS 19) for compilations and reviews is any indication, the profession is likely to be in for some difficulty in implementing the new form and content of the auditor's report. In spite of extensive advance publicity from the AICPA, a significant number of practitioners failed to implement these changes. Peer reviews have detected these failures into the second year after the effective date of SSARS 19. This will be an even more crucial failure in an audit engagement, because auditors' reports typically receive wider distribution to more sophisticated users than do compilation reports. Such a failure might cause users of the report to question the auditor's competence.

706 Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report. This section introduces the terms emphasis-of-matter and other-matter paragraphs.
- An emphasis-of-matter paragraph refers to a matter that is appropriately presented or disclosed in the financial statements.
- An other-matter paragraph refers to a matter that is not presented or disclosed in the financial statements that in the auditor's judgment is
relevant to the users’ understanding of the audit, the auditor’s responsibilities or auditor’s report.

- Emphasis-of-matter and other-matter paragraphs, when included, are required to follow the opinion paragraph and to be included in a separate section under the caption “emphasis-of-matter” or “other-matter.”

**STUDY QUESTION**

3. All of the following statements apply to the new reporting requirements under the clarified standards except:

   a. The auditor is permitted, in the paragraph of the auditor’s report covering management’s responsibility, to refer to other documents that elaborate on this responsibility.
   
   b. An emphasis-of-matter paragraph in the auditor’s report refers to a matter that is appropriately presented or disclosed in the financial statements.
   
   c. The new auditor’s report expands significantly on the auditor’s responsibilities as contrasted with those of management.
   
   d. Other-matter paragraphs, when included, are required to follow the opinion paragraph and to be included in a separate section under the caption “other-matter.”

**Special Considerations (AU-C Sections 800–899)**

800 Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks. Special purpose frameworks (formerly known as “other comprehensive bases of accounting”) are limited to cash, tax, regulatory, or contractual bases of accounting, and no longer include a definite set of criteria having substantial support that is applied to all material items in the financial statements. The clarified standard requires the auditor to:

- Obtain an understanding of the purpose and intended users of the financial statements, and of the steps taken by management to determine that the special purpose framework is acceptable in the circumstances
- Obtain management’s agreement that it acknowledges and understands its responsibilities for the informative disclosures in the financial statements, including those going beyond the specific requirements of the financial reporting framework that are necessary to achieve fair presentation
- Evaluate whether disclosures in addition to the specific requirements of the financial reporting framework are necessary to achieve fair presentation
- Obtain an understanding of significant interpretations of the contract that management has made in connection with financial statements prepared on a contractual basis of accounting, in order to evaluate whether the statements adequately describe those interpretations
Refer in the auditor’s report to management’s responsibility for determining the acceptability of the financial reporting framework, when management has a choice in determining the framework.

Describe in the auditor’s report, or refer to a note describing the purpose for which regulatory or contractual basis financial statements are prepared.

Include an emphasis-of-matter paragraph in the auditor’s report stating that the special purpose framework is a basis of accounting other than GAAP.

Include specific elements in the auditor’s report when that report is required by law or regulation to use a specific layout, form, or wording.

**OBSERVATION**

As this course entered production, the AICPA released an exposure draft of proposed amendments to AU-C section 800. Those amendments would, if they became effective, add “a definite set of logical, reasonable criteria that is applied to all material items in the financial statements” to the bases of accounting defined as special purpose frameworks. Readers of this course should stay abreast of developments on this matter by referring to the AICPA’s Web site and to CCH’s Accounting Research Manager at www.accountingresearchmanager.com.

Special Considerations in the United States (AU-C Sections 900–999)

Changes in these sections are primarily formatting changes that do not entail new substantive requirements.

**IMPLEMENTATION CONSIDERATIONS**

Since the new *Codification* will generally be effective beginning with calendar year 2012 audits, which for many auditors means the first implementation will be for field work in very early 2013, it is well to begin planning in advance for implementation. The transitional process will vary greatly according to a firm’s size and structure, and the nature of its auditing practice. The following considerations may be helpful in achieving a smooth transition.

**Develop Familiarity**

The first step toward effective implementation is to develop familiarity with the clarified standards. This includes the application and other explanatory material, appendixes, and exhibits. Identify those standards that apply to the firm’s practice and those that do not. Many firms, for example, may decline to participate in audits of group financial statements, or to perform compliance audits. For such firms, AU-C Section 600, *Special Considerations—Audits of Group Financial Statements (including the Work of Component Auditors)*, and AU-C Section 935, *Compliance Audits*, would not be applicable.
Developing familiarity should include reading the “Summary of Changes in Requirements from the Clarity Project” for the sections that are relevant to the firm’s practice. This document is located in the Financial Reporting Center of the AICPA’s Web site at www.aicpa.org. CCH also provides a comprehensive listing of materials related to the Clarity Project at its “Clarity Project Index,” which is available by subscription through its Accounting Research Manager at www.accountingresearchmanager.com.

This process should begin well in advance of the first planned engagement subject to the new standards.

**Evaluate the Effects of Changes**

Some of the changes will affect all, or nearly all, audits. Others may affect only some audits, depending on the circumstances. Firms should be alert for the presence of these matters in their evaluations:

**Changes affecting all or most audits.** Almost all audits will be affected by:

- Changes in the content of the engagement letter
- Consideration of laws and regulations, including reviews of minutes and correspondence
- Internal control communications
- External confirmations
- Changes in the auditor’s report

**Other changes.** The many other changes that may apply under differing engagement circumstances include:

- Use of service organizations
- Disclosures of segment information
- Audits of group financial statements
- Using the work of an auditor’s specialist
- Consistency of financial statements
- Use of special purpose frameworks
- Initial audits and reaudits
- Related parties
- Foreign GAAP
- Single financial statements
- Specific elements, accounts, or items of a financial statement
- Summary financial statements

Once the relevant changes have been identified, they should be evaluated to determine their effects on:

- The firm’s audit practice as a whole
- Specific engagements
Establish a Timeline

Firms should establish a timeline for transition for the firm as a whole and for each engagement. This should include:
- Reviewing the firm’s clients to determine which will be affected first
- Reviewing the firm’s audit methodologies and practice aids, to determine which will be affected first

This timeline should consider the time it will take to train staff, update firm methodologies and audit material, and communicate with clients.

Establish a Transition Team

Firms should establish a transition team or teams. This may include:
- Designating an owner or owners to become expert, and to take the lead in, understanding and implementing the new standards
- Establishing teams at various levels of the firm to develop revisions to the firm’s audit methodologies

Firms should not ignore the opportunity to include lesser-experienced staff in these teams. This will provide them with educational and professional development opportunities, and will give the firm the benefit of their perspective on the transition. This is particularly important since their perspective will necessarily be different from that of the more seasoned practitioner and since they will be the firm’s “first line” in implementing the new standards in practice.

Conduct Staff Training

Staff training should begin prior to the start of the first engagement under the new standards. Smaller firms in particular may be tempted to adopt a “learn-as-you-go” approach to implementation. This is almost certain, at its best, to lead to inefficiencies in the engagements. These will be multiplied if the firm has more than one auditor or audit team conducting different audits. At its worst, this can lead to engagements that are not in conformity with the new standards.

Many third-party providers, including the AICPA, offer training vehicles or media such as Power-Point presentations that can easily be adapted to individual firms’ needs. Thus there should be no need to spend time creating training programs or materials from scratch. Firms should, however, be careful to customize these presentations to their own needs by eliminating materials that do not apply to their practices.

In conducting training programs, firms may consider:
- Using a mix of different training modalities, which may include:
  - Live presentations
  - Short written memoranda
Third-party or internally created presentations such as webcasts
Third-party or internally created self-study programs
Detailed written materials
- Conducting multiple training sessions at different times, to ease the burden of absorbing too much material in too short a time
- Conducting varying levels of training for different levels of staff

For firms that rely on third-party practice aids, it is important that staff understand the new standards and how the third-party provider has incorporated them into the practice aids. Relying upon staff to follow new practice aids “straight out of the box” is, like the “learn-as-you-go” approach discussed above, an invitation to inefficiency and noncompliance.

**Update the Firm’s Materials**

Based on the consideration of how the new standards will affect the firm’s practice, its quality control materials, word processing templates, and other materials used in its audits will need to be updated. Updating will include, at a minimum:

- The firm’s quality control document
- The firm’s subscriptions to third-party quality control materials and practice aids
- Engagement letters
- Auditor’s reports

**STUDY QUESTION**

4. Updating of the firm’s materials for the effects of the new standards will most likely include, at a minimum, all of the following **except**:

   a. Engagement letters
   b. The firm’s subscriptions to third-party quality control materials
   c. The firm’s quality control document
   d. The audit program for cash

**Communicate with Clients**

Communicating the effects of these changes on the conduct of the audit from a client’s perspective will help engagements under the new standards run more smoothly. Many firms are using standardized client letters. Points to consider include the following.

**Engagement letters.** The client should expect a more detailed description of management’s responsibilities in the engagement letter. These responsibilities have not changed, however. Clients should also expect the firm to review
the terms of the engagement with them annually, even for recurring audits in which the terms have not changed.

**Legal and regulatory matters.** The client should expect more questions regarding the legal and regulatory framework, including a request to review correspondence with licensing and regulatory agencies.

**Confirmations.** All confirmations are now required to be written. This may require client assistance if customers or vendors are not cooperating.

**Internal control communications.** The firm’s internal control letter will now include a description, although not a quantification, of the potential effects of significant deficiencies or material weaknesses in internal control.

**New auditor’s report.** The look and content of the auditor’s report has changed. This includes paragraph headings, and a more detailed description of management’s responsibilities.

**Additional matters.** Many additional matters may not necessarily apply to all engagements. Firms should consider communicating these selectively to affected clients:

- Accounting methods other than GAAP
- Single financial statements
- Summary financial statements
- Use of service organizations
- Disclosures about segment or division information
- Group financial statements
- Initial audits
- Accounting changes
- Foreign GAAP

**STUDY QUESTION**

5. Changes in the standards that will be likely need to be communicated to all audit clients include changes in the requirements for:

   a. Audits of group financial statements
   b. Initial audits
   c. The content of engagement letters
   d. Accounting changes

**Provide Consultative Resources to Staff**

Questions will inevitably arise during the implementation process in the first cycle of audits. A well-designed education and training program will
anticipate and answer many of these questions. But others will present themselves either within the context of specific engagements, or as unanticipated concerns that do not surface until implementation begins. Following are some considerations for providing staff with the consultative resources that they need to resolve these issues.

**Designate a “Q&A” expert.** Most firms will find it efficient to designate one or more persons as experts in implementation issues and to make them available for consultation. This will save time and resources for all but the smallest firms, because this person will quickly realize the most frequent problem areas and will be able to frame ready answers for them that will provide firm-wide consistency.

**Circulate answers to “frequently asked questions.”** As the firm’s Q&A experts accumulate implementation questions, patterns will be likely to emerge. These can be summarized and communicated firm-wide, to assist staff and promote consistent implementation.

**Update practice aids.** Firms that rely on third-party practice aids will want to assure that they have current subscriptions, and that the most current edition is available to staff and placed in use. This should be stressed in staff training. Staff should be cautioned not to fall into using outdated practice aids by virtue of “rolling forward” last year’s files into the current engagement.

**Monitor Implementation**

The effectiveness of a firm’s implementation program will depend in large measure on how well it keeps its fingers on the pulse of implementation. Firms will find it necessary to monitor the progress of implementation efforts during field work, before report issuance, and post-issuance.

**Supervision during the conduct of engagements.** In order to assure effective implementation and consistency of implementation between engagements, and to avoid costly rework, firms should build additional supervisory time into the budgets for the initial round of audits under the new standards. It is crucial that this supervision take place constantly or at frequent intervals during the conduct of the engagement. This will forestall the consequence of reaching the end of a job and finding that it does not conform in some significant respect to the new standards. It is necessary because staff may not uniformly absorb training, and varying engagement circumstances may not necessarily all be addressed by even the most comprehensive training programs.

**Pre-issuance reviews.** A strong pre-issuance review program is the firm’s last line of defense to assure proper implementation. This may include
engagement quality control review as envisioned in the Quality Control Standards. It may be helpful to view this pre-issuance review as a risk-based process, similar to the audit process. The review would therefore focus on areas where noncompliance would be the most conspicuous or most damaging. These include:

- Conformity of the wording of the auditor’s report to the new standards
- Updated wording for engagement letters
- Updated content, where applicable, for communication of internal control matters

Firms should consider aggregating the results of their pre-issuance reviews during this implementation phase. This will help them to determine if common systemic threads run through their implementation that need to be addressed currently.

Post-issuance reviews and inspection. One of the values of post-issuance review is that it is conducted with hindsight, and to some extent outside of the deadlines pressures that may be associated with pre-issuance reviews. It is also an opportunity to step back from a strictly engagement-focused consideration to a more systemic and firm-wide view. Firms should not wait until the end of the implementation period to begin a program of post-issuance review or inspection. Results from these reviews should be aggregated. Firm leadership should consider their implications for the firm’s system of quality control, which includes both its training and its engagement performance. Results should be communicated within the firm to help avoid recurrence of pervasive or systemic problems.

STUDY QUESTION

6. In conducting pre-issuance reviews for compliance with the new standards, which of the following instances of noncompliance would, according to this course, likely be the most conspicuous?

   a. Failure to adopt the new wording for the auditor’s report
   b. Failure to document materiality
   c. Failure to link further audit procedures to the assessed risk of material misstatement
   d. Failure to consider relevant assertions in risk assessment
The COSO Internal Control—Integrated Framework 2012

LEARNING OBJECTIVES

Upon completion of this chapter, the reader should be able to:

- Define internal control according to the Committee of Sponsoring Organizations of the Treadway Commission’s Internal Control—Integrated Framework
- Explain the significance of the components, principles, and attributes of the Framework
- Recognize specific principles and attributes associated with the Framework's components

INTRODUCTION

The Committee of Sponsoring Organizations of the Treadway Commission’s (COSO) Internal Control—Integrated Framework (the Framework) is widely used by businesses and governments in the United States and throughout the world. In the 20 years since it was developed, business has become more complex, technologically driven, and global. Stakeholders have also become more engaged, seeking increased transparency and accountability for the integrity of internal control systems that support decision-making and governance. For these reasons, the Framework is being updated to:

- Keep it relevant in the present and future world of business
- Emphasize its relevance beyond financial reporting
- Make it easier to use

This update is expected to enable organizations to adapt to increasing complexity and the pace of change; to mitigate risks to the achievement of their objectives; and to provide reliable information to support sound decision making. The Framework’s five core components remain unchanged. However, one of the most significant enhancements in the update is the codification of those five original components into 17 principles, and 81 underlying attributes.

This update is expected to be issued in the first quarter of 2013. The COSO Board intends that the updated Framework will eventually supersede the 1992 version. While it believes that it would make sense for users to update their internal control systems and documentation as soon as practicable, the continued use of the original Framework is acceptable during
the transition. Implementation will take longer in larger, more complex organizations. Accordingly, the original Framework will continue to be available until it becomes apparent in the marketplace that the transition is substantially completed.

This course provides a broad overview of the structure of the updated Framework, including its components, principles, and attributes.

**OBSERVATION**

COSO is not a standard setter. Users of the original Framework who are required to make a public (or private) assertion as to the effectiveness of their internal control should monitor guidance from appropriate regulators and standard setters for their preferences regarding which framework to use for reporting during the transition period.

**DEFINITION**

*Internal control* is defined as a process, effected by an entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in:

- Effectiveness and efficiency of operations
- Reliability of reporting
- Compliance with applicable laws and regulations

The definition reflects the fundamental concepts that internal control is:

- A process consisting of ongoing tasks and activities, which is a means to an end, not an end in itself
- Effected by people at every level of the organization. It is not solely based on manuals, systems, and forms.
- Able to provide reasonable but not absolute assurance to the entity’s senior management and board
- Geared to the achievement of objectives in one or more categories—operations, reporting, and compliance
- Adaptable to the entity’s structure

**OBJECTIVES**

The Framework contains three categories of objectives. These allow organizations to concentrate on different aspects of internal control. The five core components of internal control apply to all three objectives.

- **Operations.** These objectives relate to the effectiveness and efficiency of the entity’s operations, which include operational and financial performance goals, and safeguarding assets against loss.
■ **Reporting.** These objectives relate to the reliability of reporting. They include both internal and external reporting, and financial and nonfinancial reporting.

■ **Compliance.** These objectives relate to adherence to applicable laws and regulations.

**STUDY QUESTION**

1. COSO’s definition of internal control reflects all of the following fundamental concepts except:
   
   a. Internal control is a means to an end, not an end in itself.
   
   b. Internal control is a process designed to provide reasonable assurance regarding the achievement of the organization’s objectives.
   
   c. Internal control is based on forms and manuals.
   
   d. Internal control is adaptable to the entity’s structure.

**HOW THE FRAMEWORK IS ORGANIZED**

The new *Framework* contains three levels of organization:

- **Components**
- **Principles**
- **Attributes**

The components are the same five that are familiar to the users of the original *Framework*. The 17 principles are systematically derived from the components to assist users in understanding the fundamental concepts underlying each component. These principles were implicit in the original *Framework*. The updated version makes them explicit.

The attributes represent characteristics associated with each of the principles. Although the *Framework* envisions that all five components and 17 principles will be present and functioning, it does not require that all attributes be present. This is because it could be possible that certain attributes of a principle might come together in various ways to effectively achieve the underlying principle.

The principles can be viewed as similar to important control objectives. Auditors, for example, will want to consider whether their clients’ systems have controls that are designed and operating to achieve each of the 17 principles. If any of the principles is absent or not functioning, an internal control deficiency exists. Whether the deficiency is a significant deficiency or a material weakness is a matter of professional judgment.

Similarly, auditors can use principles and attributes to help them better understand and assess their clients’ internal control over financial reporting. If an applicable principle is absent, or if controls are not operating effectively
to achieve a principle, the auditor needs to evaluate the control deficiency and to understand how it affects the risk of material misstatement to the financial statements.

**STUDY QUESTION**

2. Which of the following statements best expresses the Framework’s expectation about the application of its components, principles, and attributes?

   a. All five components and 17 principles will be present.
   b. All attributes will be functioning.
   c. All components, principles, and attributes will be functioning.
   d. All five components will be present and functioning, and organizations may select between alternative principles.

**OUTLINE OF THE FRAMEWORK**

This outline provides a summary of the content of each of the five components, and lists their underlying principles and attributes. The 17 principles are numbered under the headings for their respective components. The attributes are bulleted under each principle.

**Control Environment**

The control environment is the set of structures, processes, and standards that provides the basis for carrying out internal control organization-wide. The “tone at the top” regarding the importance of internal control, including expected standards of conduct, is set by the board of directors and senior management. Management reinforces these expectations throughout the organization. The control environment has a pervasive effect on the overall system of internal control. It comprises:

- The organization’s integrity and ethical values
- The parameters that enable the board to directors to carry out its governance responsibilities
- The organizational structure and assignment of authority and responsibility
- The processes for attracting, developing, and retaining competent individuals
- The rigor surrounding performance measures, incentives, and rewards to drive accountability for performance

1. The organization demonstrates commitment to integrity and ethical values. It:
   - Sets tone at the top.
2. The board of directors demonstrates independence of management, and exercises oversight for the development and performance of internal control. It:
   - Establishes board of directors oversight responsibilities.
   - Retains or delegates oversight responsibilities.
   - Applies relevant expertise.
   - Operates independently.
   - Provides oversight.

3. Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in pursuit of objectives. It:
   - Considers all structures of the entity.
   - Establishes reporting lines.
   - Defines, assigns, and limits authorities and responsibilities.

4. The organization demonstrates a commitment to attract, develop, and retain competent individuals in alignment with objectives. It:
   - Establishes policies and practices.
   - Attracts, develops, and retains individuals.
   - Evaluates competence and addresses shortcomings.
   - Plans and prepares for succession.

5. The organization holds individuals accountable for their internal control responsibilities in pursuit of objectives. It:
   - Enforces accountability through structures, authorities, and responsibilities.
   - Establishes performance measures, incentives, and rewards.
   - Evaluates performance measures, incentives, and rewards for ongoing relevance.
   - Considers excessive pressures.
   - Evaluates performance and rewards or disciplines individuals.

**Risk Assessment**

Risk assessment is a dynamic and iterative process for identifying and assessing risks to the achievement of objectives. Risks from across the entity are considered in relation to established risk tolerances. The resulting risk assessment forms a basis for deciding how risks will be managed.

Before risk can be assessed, management must:

- Establish clear objectives at differing entity levels for
  - Operations
  - Reporting
  - Compliance
Consider the impact of possible changes within the following areas that may render internal control ineffective:
- The external environment
- Its own business model

6. The organization specifies objectives with sufficient clarity to enable the identification and assessment of risks relating to objectives. It:
   - Considers tolerances for risk.
   - Reflects management’s choices.
   - Includes operations and financial performance goals.
   - Forms a basis for committing of resources.
   - Considers materiality/required levels of precision.
   - Complies with applicable accounting standards/externally established standards and frameworks.
   - Reflects entity activities.
   - Reflects external laws and regulations.

7. The organization identifies risks to the achievement of its objectives across the entity and analyzes risks as a basis for determining how the risks should be managed. It:
   - Involves appropriate levels of management.
   - Includes entity, subsidiary, division, operating unit, and functional levels.
   - Analyzes internal and external factors.
   - Estimates significance of risks identified.
   - Determines how to respond to risks.

8. The organization considers the potential for fraud in assessing risks to the achievement of its objectives. It:
   - Considers various ways in which fraud can occur.
   - Considers risk factors.
   - Assesses incentives and pressures.
   - Assesses opportunities.
   - Assesses attitudes and rationalizations.

9. The organization identifies and assesses changes that could significantly impact the system of internal control. It:
   - Assesses changes in the external environment.
   - Assesses changes in the business model.
   - Assesses changes in leadership.

Control Activities

Control activities are the actions established through policies and procedures designed to assist in ensuring that management’s directives regarding risk mitigation are carried out. These activities are performed at all entity levels, at various stages in the business process, and over the technology environment.
They may be preventive or detective, and automated or manual. Control activities may include:
- Authorizations
- Approvals
- Verifications
- Reconciliations
- Business performance reviews

Segregation of duties is normally built into these activities. Where it is not practical, management selects and develops alternative control activities.

10. The organization selects and develops control activities that contribute to the mitigation of risks to the achievement of objectives to acceptable levels. It:
   - Integrates with risk assessment.
   - Determines relevant business processes.
   - Considers entity-specific factors.
   - Evaluates a mix of control activity types.
   - Considers what level activities are applied.
   - Addresses segregation of duties.

11. The organization selects and develops general control activities over technology to support the achievement of objectives. It:
   - Determines dependency between the use of technology in business processes and technology general controls.
   - Establishes relevant technology infrastructure control activities.
   - Establishes relevant security management process control activities.
   - Establishes relevant technology acquisition, development, and maintenance process control activities.

12. The organization deploys control activities as manifested in policies that establish what is expected and in relevant procedures to effect the policies. It:
   - Establishes policies and procedures to support deployment of management’s directives.
   - Establishes responsibility and accountability for executing policies and procedures.
   - Performs using competent personnel.
   - Performs in a timely manner.
   - Takes corrective action.
   - Reassesses policies and procedures.

**Information and Communication**

**Information.** Management obtains or generates and uses relevant and quality internal and external information to support the functioning of other internal control components.
Communication. Communication is a continual, iterative process of obtaining, providing, and sharing necessary information. It is both internal and external.

Internal communication is the means by which information is distributed within the organization. Internal communication:
- Flows up, down, and across organizational levels.
- Communicates to personnel the message from senior management that internal control responsibilities are to be taken seriously.

External communication:
- Enables inbound communication of relevant external information.
- Provides information to external parties in response to requirements and expectations.

13. The organization obtains or generates and uses relevant, quality information to support the functioning of other components of internal control. It:
   - Identifies information requirements.
   - Captures internal and external sources of data.
   - Processes relevant data into information.
   - Maintains quality throughout processing.
   - Considers costs and benefits.

14. The organization internally communicates information, including objectives and responsibilities for internal control, necessary to support the functioning of other components of internal control. It:
   - Communicates internal control information with personnel.
   - Communicates with the board of directors.
   - Provides separate communication lines.
   - Selects relevant methods of communication.

15. The organization communicates with external parties regarding matters affecting the functioning of other components of internal control. It:
   - Communicates to external parties.
   - Enables inbound communications.
   - Provides separate communication lines.
   - Communicates with the board of directors.
   - Selects relevant methods of communication.

Monitoring Activities

The organization performs ongoing or separate evaluations, or some combination of the two, to determine whether each of the five components of internal control is present and functioning. Ongoing evaluations built into business processes provide timely information. Separate periodic evaluations will vary in scope and frequency depending on risk assessments, ongoing
evaluations, and other considerations. The organization evaluates findings against management’s criteria and communicates deficiencies to management and the board of directors, as applicable.

16. The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning. It:
   - Considers a mix of ongoing and separate evaluations.
   - Establishes baseline understanding.
   - Considers rate of change.
   - Uses knowledgeable personnel.
   - Integrates with business processes.
   - Objectively evaluates.
   - Adjusts scope and frequency.

17. The organization evaluates and communicates internal control deficiencies in a timely manner to those parties responsible for taking corrective action, including senior management and the board of directors, as appropriate. It:
   - Assesses results.
   - Communicates deficiencies to management.
   - Reports deficiencies to senior management and the board of directors.
   - Monitors corrective action.

STUDY QUESTION

3. Which of the following principles underlies the control environment component of internal control?

   a. The organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning.
   
   b. The organization obtains or generates and uses relevant, quality information to support the functioning of other components of internal control.
   
   c. The organization identifies and assesses changes that could significantly impact the system of internal control.
   
   d. Management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in pursuit of objectives.

CPE NOTE: When you have completed your study and review of chapters 11–13, which comprise Module 4, you may wish to take the Quizzer for this Module.

Go to CCHGroup.com/PrintCPE to take this Quizzer online.
MODULE 1 — CHAPTER 1

1. **a. Incorrect.** The Yellow Book does not use the perceptions of the general public as a touchstone for gauging independence in appearance.
   **b. Correct.** The Yellow Book states that independence in appearance is the absence of circumstances that would cause a reasonable and informed third party with knowledge of relevant information to believe that the integrity, objectivity, or professional skepticism of an individual auditor or an audit organization had been compromised.
   **c. Incorrect.** The capability of an audit organization to maintain a collective state of mind that permits it to perform an audit without being affected by influences that compromise its professional judgment is important to auditor independence. It is not, however, cited by the Yellow Book as a characteristic of independence in appearance.
   **d. Incorrect.** Constitutional or statutory provisions under which the governmental audit organization is in a different branch of government than the audited entity may constitute a safeguard against threats to independence, but they are not named by the Yellow Book as a characteristic of independence in appearance.

2. **a. Incorrect.** The Yellow Book defines a structural threat as a threat that an audit organization’s placement within the organizational structure of a government entity being audited will affect its ability to perform and report on the audit objectively.
   **b. Incorrect.** The Yellow Book defines a familiarity threat as a threat that an auditor will take a position that is not objective due to aspects of a relationship with management or with the audited entity’s personnel.
   **c. Incorrect.** The Yellow Book defines bias as a threat that an auditor will take a position that is not objective due to personal convictions.
   **d. Correct.** The Yellow Book discusses political pressures in connection with the independence of internal auditors. It does not, however, list political influence as one of the seven threats to independence.

3. **a. Correct.** The Yellow Book states that a governance structure at the audited entity that provides appropriate oversight and communication concerning the audit organization’s services can be a safeguard. However, this safeguard operates at the audited entity level, not at the audit organization level, and cannot be solely relied upon to reduce or eliminate a threat.
b. Incorrect. Involving another audit organization to perform, or to reperform, part of the audit is one of the safeguards that can be applied by an audit organization to reduce or eliminate threats to independence, according to the Yellow Book.

c. Incorrect. The Yellow Book states that review of audit work by a professional staff member who was not a part of the audit team can be performed at the audit organization as one of the safeguards to reduce or eliminate a threat to independence.

d. Incorrect. Consultation with an independent third party is listed by the Yellow Book as one of the safeguards that can be applied by an audit organization to reduce or eliminate threats to independence.

4. a. Incorrect. Providing advice to the audited entity on routine business matters is not considered a nonaudit service by the Yellow Book, and is not prohibited.

b. Incorrect. The Yellow Book does not prohibit an auditor from educating an audited entity’s personnel on accounting matters, and does not consider this a nonaudit service.

c. Correct. When an auditor maintains custody of audited entity assets, the management participation threat becomes so strong that no safeguard can reduce it to an acceptable level. For this reason, auditors may not perform this activity.

d. Incorrect. The Yellow Book considers providing an audited entity with readily available best practices information as a routine activity that auditors may perform in connection with an audit, and does not prohibit it.

5. a. Incorrect. Preparing account reconciliations that identify reconciling items for management’s evaluation is a nonaudit service that is allowable if certain requirements are met and safeguards have been applied to eliminate or reduce threats to independence to an acceptable level.

b. Correct. The Yellow Book lists the making disbursements on behalf of an audited entity’s employee benefit plan as a nonaudit service that always impairs independence and thus may not be performed.

c. Incorrect. Provided that certain requirements are met and safeguards have been applied to eliminate or reduce threats to independence to an acceptable level, posting entries that have been approved by management to the entity’s trial balance is an allowable nonaudit service.

d. Incorrect. The Yellow Book considers recording transactions for which management has approved appropriate account classifications to be an allowable nonaudit service as long as certain requirements are met and safeguards have been applied to eliminate or reduce threats to independence to an acceptable level.
6. Which of the following is a documentation requirement of *Government Auditing Standards* that exceeds the requirements of GAAS?

a. *Incorrect.* Both *Government Auditing Standards* and GAAS require documentation of an understanding with management or those charged with governance about the audited entity’s acceptance of its responsibilities with respect to nonaudit services.

b. *Incorrect.* Neither *Government Auditing Standards* nor GAAS require the auditor to document threats to independence that do not rise to an unacceptable level.

c. *Correct.* Documentation of the auditor’s consideration of whether the audited entity’s management has suitable knowledge, experience or skill to oversee nonaudit services is required by *Government Auditing Standards*, but not by GAAS.

d. *Incorrect.* Documentation of the objectives of nonaudit services is required by both *Government Auditing Standards* and GAAS.

**MODULE 1 — CHAPTER 2**

1. a. *Incorrect.* There is no requirement in GAGAS for auditors to detect abuse in financial audits. However, if auditors become aware of abuse that could be material, they are required apply audit procedures directed toward ascertaining its effects on the subject matter of the audit.

b. *Correct.* Auditors are required under GAGAS to extend the procedures envisioned in the AICPA’s standards related to fraud and noncompliance with laws and regulations to the consideration of compliance with the provisions of contracts or grant agreements.

c. *Incorrect.* Abuse may not necessarily involve either fraud or noncompliance. Rather, it is based on a standard of conduct that prudent persons would consider reasonable and necessary given the facts and circumstances.

d. *Incorrect.* Abuse includes misuse of authority or position for financial gain, whether personal, family or business.

2. a. *Incorrect.* The Yellow Book states that factors outside of program management’s control often contribute to findings, and should be considered in developing the cause element of a finding.

b. *Incorrect.* It is the cause element, rather than the effect element of a finding identifies reasons or explanations for the condition, and factors accounting for the differences between the criteria and the condition.

c. *Correct.* The component of a finding that provides a link between the condition, which is the existing situation, and the criteria, which is the expected or desired state, is the effect element.

d. *Incorrect.* The criteria element of a finding, rather that the condition element, provides a context for evaluating evidence and understanding findings.
3. a. **Incorrect.** GAGAS allows auditors to issue separate reports conforming only to GAAS or other standards.
   b. **Incorrect.** Auditors may issue a report when the audited entity refuses to comment on audit findings. That report should state that the entity did not provide comments.
   c. **Incorrect.** GAGAS requires that findings that are less than material, but warrant the attention of those charged with governance be communicated in writing.
   d. **Correct.** In reporting on information that is classified or prohibited by law or regulation from general disclosure, auditors may issue a separate, limited-use or classified report. That report should be distributed only to those persons authorized to receive such information.

**MODULE 1 — CHAPTER 3**

1. a. **Incorrect.** The Yellow Book states that **reliability**, rather than **validity**, relates to the consistency of results when information is measured or tested.
   b. **Correct.** The Yellow Book defines **validity** as the extent to which evidence represents what it is purported to represent.
   c. **Incorrect.** The Yellow Book states that **relevance**, rather than **validity**, is the extent to which evidence has a logical relationship with the issue being addressed.
   d. **Incorrect.** The Yellow Book states that **sufficiency**, rather than **validity**, is a measure of the quality of evidence used for addressing the audit objectives and supporting findings and conclusions.

2. a. **Incorrect.** The determination of whether fraud has actually occurred is outside of the auditor’s professional capabilities. This determination can only be made by judicial process.
   b. **Incorrect.** The Yellow Book specifically states that the auditor is not required to detect abuse in a performance audit.
   c. **Incorrect.** The Yellow Book imposes no requirement for the auditor to report suspected fraud or abuse directly to law enforcement officials.
   d. **Correct.** The Yellow Book states that the auditor is responsible for gathering and assessing information to identify significant fraud risks.

3. a. **Incorrect.** The Yellow book states that auditors may communicate these matters in an engagement letter but does not require them to do so. It does, however, require them to document the communication of these matters.
   b. **Correct.** Auditors are required to communicate an overview of the audit’s objectives, scope, methodology, timing, and planned reporting both to management and to those charged with governance.
c. Incorrect. The Yellow Book contains no requirement for auditors to communicate an overview of the audit’s objectives, scope, methodology, timing, and planned reporting to regulatory authorities.

d. Incorrect. In cases of suspected fraud, communication of the audit’s objectives, scope, methodology, and timing could compromise the auditors’ ability to obtain audit evidence. For this reason, the Yellow Book specifically exempts auditors from making this communication under these circumstances.

4. a. Correct. The Yellow Book contains a presumptively mandatory requirement that auditors should determine whether there is enough appropriate evidence to address audit objectives and to support audit findings and conclusions. This, however, is not an unconditional requirement.

b. Incorrect. The Yellow Book requires that auditors must obtain sufficient, appropriate evidence to provide a reasonable basis for their findings and conclusions.

c. Incorrect. The Yellow Book requires that audit supervisors or those designated to supervise auditors must properly supervise audit staff.

d. Incorrect. The Yellow Book requires that in all cases, auditors must prepare a written audit plan (also commonly known as an audit program) for each audit.

5. a. Incorrect. The actual requirement is for the auditor to make this report when the audited entity’s management fails to make communications to external parties that are required by law or regulation, and after, not before, the auditor communicates the failure to those charged with governance.

b. Correct. Auditors are required to report known or likely fraud, noncompliance, or abuse directly to outside parties when the audited entity’s management fails to take timely and appropriate action to respond to known noncompliance, and the auditors have first communicated that failure to those charged with governance.

c. Incorrect. When auditors are not able to obtain evidence, such as confirmation, to corroborate management’s assertion that they have properly reported fraud, noncompliance, or abuse to external parties, the auditors should report directly to the external parties.

d. Incorrect. The reporting requirements are in addition to any legal reporting requirements. They should be complied with even if the auditors have been dismissed or have resigned. However, auditors are not required to wait until after dismissal or resignation.

6. a. Incorrect. The Yellow Book states a preference for, but does not require, auditors to obtain written comments from responsible officials concerning their views about the audit’s findings. It states that auditors may accept oral responses.
b. Incorrect. Auditors cannot require the audited entity to revise its comments. When those comments are inconsistent or in conflict with the draft audit report, auditors should, rather, evaluate the validity of the comments, and should explain disagreements in the report.

c. Incorrect. Auditors may issue a report without receiving comments from the audited entity, when it does not provide comments within a reasonable time or refuses to comment. In this case, the audit report should state that the entity did not provide comments.

d. Correct. The Yellow Book requires that auditors include an evaluation of the audited entity’s comments in the audit report, as appropriate.

MODULE 2 — CHAPTER 4

1. a. Incorrect. The fair presentation of the financial statements in accordance with the applicable financial reporting framework is one of management’s responsibilities, according to SSARS 19, and should be addressed in the accountant’s compilation report.

b. Incorrect. Management is responsible for designing internal controls relevant to the preparation and fair presentation of the financial statements, according to SSARS 19. The responsibility should be addressed in the accountant’s compilation report.

c. Correct. According to SSARS 19, it is the responsibility of the accountant to conduct the compilation engagement in accordance with SSARS.

d. Incorrect. Management is responsible for the preparation of the financial statements in accordance with the applicable financial reporting framework. SSARS 19 states that this responsibility should be addressed in the accountant’s compilation report.

2. a. Incorrect. There is no requirement that an understanding be established with those charged with governance regarding the services to be rendered in a review engagement.

b. Incorrect. SSARS 19 does not allow an option of leaving the understanding with management regarding the services to be rendered in a compilation engagement as an oral understanding. It requires the understanding to be written.

c. Incorrect. The timing of client acceptance, whether before or after the effective date of SSARS 19, does not affect its requirements for establishing an understanding with those clients. Firms should have this understanding with clients that existed before the effective date of SSARS 19, as well as for new clients.

d. Correct. SSARS 19 requires accountants to establish and to document an understanding with management regarding the services to be rendered in both compilation and review engagements.
3. a. Correct. One of the minimum requirements for management representations in a review engagement under SSARS 19 is that management has responded fully and truthfully to all of the accountant’s inquiries.

b. Incorrect. While accountants normally inquire about significant matters covered in the corporate minutes, there is no requirement for management to make a representation about their completeness.

c. Incorrect. There is no requirement for management to make representations about the details of all consultations with legal counsel. Many legal consultations would have little or no relevance to the financial statements and thus representations about them would not be necessary or useful. However, where consultations relate to matters that could have significant financial statement effects, the accountant might choose to request representations.

d. Incorrect. Management is responsible for the fair presentation of the financial statements, which includes the completeness of the related disclosures.

MODULE 2 — CHAPTER 5

1. a. Incorrect. The preface contains a section covering the auditor’s responsibilities in conducting an audit.

b. Correct. The AICPA Code of Professional Conduct and the rules of state boards of accountancy and applicable regulatory agencies contain standards for independence, integrity, and objectivity in conducting an audit. The preface does not contain such a section.

c. Incorrect. The preface to the new Codification addresses reporting on an audit.

d. Incorrect. The purpose of an audit is one of the sections contained in the preface to the new Codification.

2. a. Incorrect. One of the premises upon which an audit is conducted is that management, and not the auditor, is responsible for the fair presentation of the financial statements in accordance with the applicable financial reporting framework.

b. Incorrect. One of the premises upon which an audit is conducted is that management, and not the auditor, is responsible for the design of internal controls.

c. Incorrect. Management is responsible for providing the auditor with access to persons within the entity from whom the auditor determines that it is necessary to obtain audit evidence. This determination is the auditor’s, not management’s.

d. Correct. One of management’s responsibilities in an audit is to provide the auditor with information, such as records and documentation, needed to conduct the audit.
3. **a. Incorrect.** Reasonable assurance is a high rather than a moderate level of assurance.
   b. **Incorrect.** Reasonable assurance includes the assurance that the financial statements are free from material misstatement due to fraud or error.
   c. **Correct.** Reasonable assurance involves, among other things, obtaining sufficient appropriate audit evidence about whether material misstatements exist through designing and implementing appropriate audit responses to assessed risk of material misstatement.
   d. **Incorrect.** Absolute assurance is not attainable due to several inherent limitations, including those of audit procedures. However, these limitations do not prevent the auditor from attaining reasonable assurance.

**MODULE 2 — CHAPTER 6**

1. **a. Incorrect.** FASB Concepts Statements are defined as nonauthoritative guidance.
   b. **Incorrect.** AICPA Issues Papers are defined as nonauthoritative guidance.
   c. **Correct.** Since its publication, the FASB Accounting Standards Codification has become the sole authoritative source of U.S. GAAP for nonpublic nongovernmental entities.
   d. **Incorrect.** AICPA Statements on Standards for Accounting and Review Services do not address GAAP, but rather the compilation and review of financial statements.

2. **a. Incorrect.** Practitioners need not be aware of all of the “other publications” that are applicable to their auditing, attestation, and compilation and review engagements.
   b. **Correct.** The Standards require practitioners to be familiar with the “interpretive publications” applicable to their engagements, and to consider their guidance in planning and performing those engagements.
   c. **Incorrect.** “Other publications” have no authoritative status, and are below “interpreative publications” in the hierarchy of professional standards.
   d. **Incorrect.** Practitioners have no obligation to consider the guidance in “other publications” or to explain not applying it.

3. **a. Incorrect.** A compilation and review article in the Journal of Accountancy is considered an “other compilation and review publication” rather than an “interpreative publication.”
   b. **Incorrect.** The annual AICPA Compilation and Review Alert is considered an “other compilation and review publication” rather than an “interpreative publication.”
   c. **Incorrect.** Statement on Standards for Accounting and Review Services No. 19 represents the authoritative standards for compilation and review engagements.
d. Correct. Compilation and review guidance included in AICPA Audit and Accounting Guides is falls within the classification of “interpretive publications” for purposes of applying SSARS.

MODULE 2 — CHAPTER 7

1. a. Incorrect. When the risk of material misstatement of revenue due to cutoff errors is assessed as high, most auditors would not likely consider substantive analytical procedures by themselves to provide sufficient audit evidence. In this case, substantive tests of details targeted at determining proper revenue cutoff would ordinarily be indicated.
   b. Correct. When the risk of material misstatement of immaterial recorded accrued expenses due to incompleteness is assessed as low, most auditors would be likely to consider limiting further audit procedures in this area to substantive analytical procedures.
   c. Incorrect. When the risk of material misstatement of accounts payable due to incompleteness is assessed as low, most auditors would not be likely to consider an extensive search for unrecorded liabilities through inspection of subsequent disbursements to be necessary.
   d. Incorrect. When the risk of material misstatement of occupancy expenses due to incorrect cutoff is assessed at low, most auditors would consider substantive analytical procedures to be an efficient and effective alternative to performing extensive invoice vouching.

2. a. Incorrect. Because management has accurate records and is capable of understanding the entry to record doubtful accounts, this would not ordinarily constitute a control deficiency.
   b. Correct. Because management lacks the skills and knowledge necessary to evaluate the appropriateness of depreciation methods and the calculation of depreciation expense, this constitutes a control deficiency, which might be either a significant deficiency or a material weakness.
   c. Incorrect. Because management has a system that keeps an accurate record of accrued vacation pay, the fact that it chooses to leave adjustment of the liability to the auditor would not ordinarily be considered a control deficiency.
   d. Incorrect. Because management provides the auditor with a complete list of accounts payable for posting as a part of the audit, this would not ordinarily be considered a control deficiency.

3. a. Incorrect. Professional standards continue to require that the communication to management of significant deficiencies and material weaknesses be in writing.
b. Incorrect. One significant change brought about by the new standards is that the communication to management of significant deficiencies and material weaknesses should include an explanation of their potential effects.

c. Incorrect. Professional standards continue to require that the communication to management of significant deficiencies and material weaknesses be made within 60 days of the report release date.

d. Correct. Oral communication to management of significant deficiencies and material weaknesses is not by itself sufficient under current professional standards.

4. a. Incorrect. Both the form and content of the new auditor's report have significantly changed the auditor's report that was previously required.

b. Correct. In an effort to assist users of the report differentiate the responsibilities of management for the financial statements from those of the auditor, the new auditor's report contains a paragraph that describes the auditor's responsibility.

c. Incorrect. The new standards prohibit the auditor from modifying the standard report language that describes management's responsibility for the financial statements.

d. Incorrect. The new auditor's report permits the auditor to report on other legal or regulatory requirements in a separate section from the report on the financial statements.

5. a. Incorrect. The predecessor auditor's work may provide the current auditor with evidence about opening balances, but the predecessor auditor does not determine the current auditor's conclusions about those balances.

b. Incorrect. The entity's management is not responsible for the auditor's conclusions about opening balances.

c. Correct. Under the new standards, the current auditor is solely responsible for the conclusions about opening balances in the current period audit.

d. Incorrect. Those charged with governance are not responsible for the auditor's conclusions about opening balances.

6. a. Incorrect. There is no requirement in the standards for any particular type of engagement to be subjected to EQCR.

b. Correct. EQCRs are required to be conducted by persons with no previous connection to the engagement.

c. Incorrect. EQCRs may not be conducted by the engagement partner or by members of the engagement team.

d. Incorrect. EQCR may not be conducted after the engagement is issued.
MODULE 3 — CHAPTER 8

1. a. Incorrect. SAS 124 specifically states that it does not prohibit the use of foreign GAAP financial statements within the United States.
   b. Incorrect. The IASB is one of the four bodies presently designated by the AICPA Council to establish accounting principles. Therefore, SAS 124 does not apply to financial statements prepared in accordance with those standards.
   c. Incorrect. SAS 124 specifically states that it does not apply to statements of a U.S. subsidiary of a foreign registrant parent company that are presented in the parent company’s filing with the Securities and Exchange Commission.
   d. Correct. SAS 124 applies to financial statements prepared in accordance with a foreign GAAP that are intended for use outside the United States.

2. a. Incorrect. There is no requirement in U.S. professional standards for the auditor to apply the GAAS of the foreign country in these circumstances. The terms of the engagement, however, may include such a requirement.
   b. Incorrect. There is no requirement in U.S. professional standards for the auditor to apply the ISAs in these circumstances. The terms of the engagement, however, may include such a requirement.
   c. Correct. When engaged to audit foreign GAAP statements that are intended for use only outside the United States, the auditor should apply U.S. GAAS, except for requirements related to the form and content of report.
   d. Incorrect. There is no requirement in U.S. professional standards for the auditor to apply both U.S. GAAS and the GAAS of the foreign country in these circumstances. The terms of the engagement, however, may include such a requirement.

3. a. Correct. SAS 124 permits auditors to issue one report for use outside the United States and one for use inside when reporting on foreign GAAP statements that are intended for use both inside and outside the United States.
   b. Incorrect. The reporting provisions of the ISAs do not apply to foreign GAAP financial statements that are intended for use within the United States.
   c. Incorrect. There is no requirement, under these circumstances, for an auditor to use the report form and content of the foreign country.
   d. Incorrect. There is no requirement for auditors to quantify the effects on the foreign GAAP financial statements of departures from U.S. GAAP.

MODULE 3 — CHAPTER 9

1. a. Incorrect. Information that a designated accounting standard setter requires to accompany an entity’s basic financial statements is the definition of required supplementary information as set forth in SAS 120.
b. Correct. SAS 119 defines supplementary information as information, other than required supplementary information, presented outside the basic financial statements that is not considered necessary in order for the financial statements to be fairly presented in accordance with the applicable financial reporting framework.

c. Incorrect. Financial information other than the financial statements and auditor’s report that is included in a document that contains audited financial statements and the auditor’s report on those statements is one component of other information as defined in SAS 118.

d. Incorrect. Nonfinancial information other than the financial statements and auditor’s report that is included in a document that contains audited financial statements and the auditor’s report on those statements is one component of other information as defined in SAS 118.

2. a. Incorrect. SAS 119 requires the auditor’s report to state that the supplementary information has been subjected to the auditing procedures applied in the audit of the financial statements. However, this statement does not represent a change from previous standards.

b. Incorrect. The requirement to state that the audit was conducted for the purpose of forming an opinion on the financial statements as a whole existed in previous standards, and continues to be a requirement under SAS 119.

c. Incorrect. The requirement to state that the supplementary information is presented for purposes of additional analysis, and is not a required part of the financial statements existed in previous standards, and continues to be a requirement under SAS 119.

d. Correct. SAS 119 now requires that auditors, in their reports on supplementary information, state that the information has been derived from and relates directly to the underlying accounting and other records used to prepare the financial statements. The previously required report wording did not enumerate these specific procedures.

3. a. Incorrect. Omission of required supplementary information does not affect the auditor’s opinion on the basic financial statements because it is not a part of the basic financial statements.

b. Incorrect. There is no provision in SAS 120 that either requires or allows auditors to withhold an opinion on the basic financial statements based on the omission of required supplementary information.

c. Correct. Because required supplementary information is not a part of the basic financial statements, a material misstatement within the required supplementary information has no affect on the auditor’s opinion on the basic financial statements.
d. Incorrect. Because required supplementary information would never be presented apart from the basic financial statements, there is no provision in SAS 120 that allows auditors to report separately on it.

4. a. Correct. SAS 118’s reporting requirements are targeted to the effects of material inconsistencies or misstatements of fact on the auditor’s report on the financial statements, not on the other information as such. Auditors are required to consider the effects of material inconsistencies or misstatements of fact on the financial statements and the related auditor’s report.

b. Incorrect. SAS 118 permits, but does not require auditors to disclaim an opinion on other information in an other-matters paragraph to the auditor’s report on the financial statements. An example paragraph for this purpose is included in the application and other explanatory material.

c. Incorrect. SAS 118 places no requirement on auditors to report on other information.

d. Incorrect. SAS 118 permits, but does not require auditors to withhold their reports on the financial statements when uncorrected material misstatements of fact are identified.

5. a. Incorrect. Neither SSARS 19 nor the interpretations hereunder impose a requirement to apply compilation procedures to required supplementary information. However, nothing prohibits an accountant from compiling required supplementary information if engaged to do so.

b. Incorrect. Since required supplementary information would not be issued apart from the basic financial statements, there is no provision in SSARS for a separate report on such information.

c. Correct. The interpretation to SSARS 19 provides example wording for explanatory paragraphs covering a variety of circumstances related to required supplementary information. One of these examples address cases when the required supplementary information is presented and the accountant did not compile it.

d. Incorrect. The interpretation to SSARS 19 states that the accountant may modify the standard compilation report by including a separate paragraph that refers to the required supplementary information and explains the circumstances regarding its presentation. It does not impose a requirement to do so.

6. a. Incorrect. There is no requirement for the accountant to apply review procedures to supplementary information.

b. Correct. SSARS 19 requires that the accountant’s review report clearly indicate the degree of responsibility, if any, taken with respect to the supplementary information.
c. Incorrect. SSARS 19 states that an explanation regarding the supplementary information should be included either in the review report or in a separate report. There is no requirement that the explanation must be included in the review report.

d. Incorrect. Supplementary information (except for required supplementary information) is not required to accompany basic financial statements. Therefore, the accountant has no responsibility to report on its absence.

MODULE 3 — CHAPTER 10

1. a. Incorrect. This standard applies when the most recent annual financial statements have been audited by a predecessor auditor.
   b. Correct. Reviews of financial statements under the Statements of Standards on Accounting and Review Services are a distinct service from an engagement to review interim financial information under AU-C section 930, Interim Financial Information. This standard does not apply to engagements under SSARS.
   c. Incorrect. This standard applies when the auditor has been engaged to audit the entity’s current year statements.
   d. Incorrect. This standard applies when the interim financial information and the annual financial statements have been prepared under the same financial reporting framework.

2. a. Incorrect. As a condition for accepting engagements under this standard, auditors are required to obtain management’s agreement to certain responsibilities. One of those is to provide the auditor with access to all relevant information that it is aware of.
   b. Incorrect. This standard requires a written agreement between the auditor and client.
   c. Correct. An identification of the applicable financial reporting framework should be included in the agreement between the auditor and the client. Auditors are required to determine the acceptability of the financial reporting framework to be used.
   d. Incorrect. This standard requires that the agreement to provide services include the limitations of the review engagement, such as that it does not provide a basis for expressing an opinion, and does not provide certain of the assurances normally associated with an audit.

3. a. Correct. This standard requires auditors to compare interim financial information with comparable information for the immediately preceding interim period if applicable.
   b. Incorrect. This standard requires auditors to consider plausible relationships among financial and nonfinancial data, where relevant. It does not require the auditor to calculate that nonfinancial data.
c. Incorrect. This standard requires a comparison of disaggregated revenue data. There is no such requirement for expense data.

d. Incorrect. Vouching of transactions is a substantive audit procedure that is not required and not ordinarily contemplated in a review of interim financial information.

4. a. Correct. Under this standard, an auditor is not required to obtain corroborative evidence to support management’s responses to inquiries.

b. Incorrect. Reading minutes to identify matters that may affect the interim financial information is listed as a procedure ordinarily included under this standard.

c. Incorrect. Reading interim financial information to consider whether it is in accordance with the applicable financial reporting framework is listed as a procedure ordinarily included under this standard.

d. Incorrect. Inquiring about subsequent events is listed as a procedure ordinarily included under this standard.

5. a. Correct. This standard requires communication of detected instances of noncompliance with laws or regulations except those that are clearly inconsequential.

b. Incorrect. Matters pertaining to the interim financial information that would ordinarily be communicated to those charged with governance in an audit of financial statements under GAAS should also be communicated in an engagement conducted under this standard.

c. Incorrect. This standard requires that material weaknesses in internal control be communicated to those charged with governance.

d. Incorrect. Fraud involving senior management should be communicated directly to those charged with governance, according to this standard.

6. a. Incorrect. This standard states that if the auditor’s report is modified for a material departure from the applicable financial reporting framework, the report should state the effects of the departure if practicable. It does not impose an unconditional requirement to do so.

b. Correct. This standard requires auditors to determine that each page of the interim financial information accompanying their review report is clearly marked as “unaudited.”

c. Incorrect. If the interim financial information is not prepared in accordance with the applicable financial framework in all material respects, the auditor should first consider whether modification of the review report is sufficient to address the departure. Withdrawal from the engagement would be premature prior to making that consideration.
d. Incorrect. When current period interim financial information that the auditor has reviewed is presented in comparative form with interim information of a prior period that has not been reviewed, the review report should indicate that the auditor assumes no responsibility for the prior period information.

MODULE 4 — CHAPTER 11

1. a. Incorrect. When an auditor is engaged to perform a separate attest engagement on the entity’s compliance with the requirements of specific laws, rules or regulations, the requirements of AT section 601, Compliance Attestation, apply.

b. Correct. The requirements of SAS 125 apply only when an auditor is engaged to report on compliance with aspects of contractual agreements or regulatory requirements as a by-product of a financial statement audit.

c. Incorrect. SAS 125 does not address reporting on compliance with contractual or regulatory requirements for purposes of a judicial proceeding.

d. Incorrect. When an auditor is engaged to perform a compliance audit in accordance with GAAS and Government Auditing Standards, and there is a governmental requirement that the auditor express an opinion on compliance, the requirements of SAS 117, Compliance Audits, apply.

2. a. Incorrect. One of the preconditions for issuing a compliance report that identifies no instances of noncompliance is that the covenants or regulatory requirements relating to accounting matters have been subjected to the audit procedures applied in the financial statement audit.

b. Correct. A qualified opinion on the financial statements does not preclude an auditor from issuing a compliance report that identifies no instances of noncompliance.

c. Incorrect. SAS 125 applies to the auditor’s responsibilities when requested to report on an entity’s compliance with aspects of contractual agreements or regulatory requirements related to accounting matters in connection with an audit of financial statements. An auditor who has not been engaged to audit the financial statements under GAAS would have no basis for issuing such a compliance report.

d. Incorrect. Nothing in SAS 125 precludes an auditor from issuing a compliance report combined with the auditor’s report on the financial statements.

3. a. Incorrect. Instances of noncompliance should be reported even when a waiver has been obtained.

b. Incorrect. SAS 125 does not address materiality. Thus there is no reporting exception for apparently immaterial instances of noncompliance.
c. Incorrect. It is correct that SAS 125 requires all identified instances of noncompliance to be reported. However, because there are additional reporting requirements associated with noncompliance, this is not the best of listed answers.

d. Correct. SAS 125 requires that all identified instances of noncompliance to be reported. It also requires that the report refer to the specific covenants or paragraphs of the contract or regulation associated with the noncompliance.

MODULE 4 — CHAPTER 12

1. a. Incorrect. Auditing Interpretations are codified with a 9000-series number, followed by the number of the AU-C section to which they pertain. For example, the auditing interpretation entitled Audit Documentation: Auditing Interpretations of Section 230 is numbered as AU-C Section 9230. This Interpretation appears directly after AU-C Section 230 in the new Codification.

   b. Correct. The AU-C numbers are a temporary designation, to distinguish these sections from the previous AU sections during the transition period. They will revert to AU numbers in 2014, by which time their content will be fully effective for all engagements.

   c. Incorrect. Application and Other Explanatory Material paragraphs are designated by the letter A followed by a number, so that they can be readily distinguished from the content of the main body of each AU-C section.

   d. Incorrect. The numbering sequence for the AU-C sections roughly follows the chronology of a typical audit engagement. Thus, the sections for risk assessment, for example, appear before the sections for audit evidence and reporting.

2. a. Incorrect. The clarified standard on audits of group financial statements focuses on how to conduct an effective audit of group financial statements, rather than on how to conduct an audit that involves other auditors. This standard better articulates the link between the risk assessment standards and group financial statement audits. It is significantly broader in scope than the previous standard.

   b. Correct. The clarified standard on related parties is actually framework-neutral. It applies whether or not the entity’s financial reporting framework establishes requirements for related party disclosures.
c. Incorrect. The clarified standard on opening balances states that the auditor is responsible for determining whether prior period closing balances are brought forward correctly and reflect appropriate application of accounting policies, and for evaluating whether current period audit procedures provide evidence about opening balances by means of either performing specific procedures related to opening balances or reviewing a predecessor auditor’s work. Reviewing a predecessor’s audit documentation cannot by itself provide sufficient appropriate evidence regarding opening balances.

d. Incorrect. The clarified standard on communicating internal control matters requires auditors to include in their written communication an explanation of the potential effects of the significant deficiencies and material weaknesses identified. It does not, however, require them to quantify those effects.

3. a. Correct. The auditor is prohibited, under the new standards, from elaborating in the auditor’s report about management’s responsibility, or making any reference to another document that does so. This might lead users of the report to the erroneous conclusion that the auditor is expressing assurances about any representations made by management concerning its responsibilities.

b. Incorrect. The emphasis-of-matter paragraph is a new concept in the clarified standards. It is used in the auditor’s report to refer to a matter that is appropriately presented or disclosed in the financial statements.

c. Incorrect. The new auditor’s report contains paragraphs that expand significantly on the auditor’s responsibilities as contrasted with those of management.

d. Incorrect. Other-matter paragraphs are a new concept in the clarified standards. When present in the auditor’s report, they are required to follow the opinion paragraph and to be included in a separate section under the caption “other-matter.”

4. a. Incorrect. Engagement letters will need to be updated to reflect changes in standards, particularly as they pertain to management’s responsibilities in the audit.

b. Incorrect. If the firm is relying on outdated practice aids after the effective date of the new standards, it will most likely be out of compliance with the new standards. Thus, maintaining current subscriptions to third-party practice aids is crucial during the implementation of the new standards.

c. Incorrect. The firm’s quality control document will likely need to be updated to reflect changes in the firm’s audit methodologies resulting from the new standards.

d. Correct. The new standards do not contain significant substantive changes in the requirements for auditing cash; thus the audit program would be unlikely to change significantly.
5. a. **Incorrect.** Most firms would likely choose to communicate changes in requirements for audits of group financial statements only in engagements involving group financial statements.  

b. **Incorrect.** Most firms would likely choose to communicate changes in requirements for initial audits only on such audits.  
c. **Correct.** The new standards require a more detailed discussion of management’s responsibilities in an audit. This is required content for all engagement letters.  
d. **Incorrect.** Most firms would likely choose to communicate changes in requirements for auditing accounting changes only where such changes have occurred.  

6. a. **Correct.** Auditors’ reports often receive wide distribution to a variety of sophisticated users. A failure to adopt the new wording for the auditor’s report thus has the potential to be publicly conspicuous, and to damage the auditor’s professional reputation.  
b. **Incorrect.** Failure to document materiality would be a serious shortcoming in any audit. However, there have not been substantive changes in this requirement in the new standards, and this failure would not be likely be noticeable except to persons with access to the audit documentation.  
c. **Incorrect.** Failure to link further audit procedures to the assessed risk of material misstatement would be a serious shortcoming in any audit. However, there have not been substantive changes in this requirement in the new standards, and this failure would not be likely be noticeable except to persons with access to the audit documentation.  
d. **Incorrect.** Failure to consider relevant assertions in risk assessment would be a serious shortcoming in any audit. However, there have not been substantive changes in this requirement in the new standards, and this failure would not be likely be noticeable except to persons with access to the audit documentation.  

**MODULE 4 — CHAPTER 13**  

1. a. **Incorrect.** The Framework stresses that internal control is not an end in itself, but rather a means to an end.  
b. **Incorrect.** The Framework gives primacy to the human element of internal control. The process is designed to provide reasonable, but not absolute, assurance regarding the achievement of the organization’s objectives.  
c. **Correct.** Internal controls are to some extent dependent on systems, forms, and manuals, but these are not the most important part of internal control. Internal control depends on people at every level of the organization.  
d. **Incorrect.** The Framework recognizes differences between organizations. Thus, internal control systems are adaptable to each entity’s structure.
2. a. Correct. The Framework envisions that all five components and 17 principles will be present in an effective system of internal control.
   b. Incorrect. The Framework does not require that all attributes be present, because it could be possible that certain attributes of a principle might come together in various ways to effectively achieve the underlying principle.
   c. Incorrect. While the Framework envisions that all components and principles will be functioning in an effective system of internal control, this does not apply to the attributes.
   d. Incorrect. The Framework does not view the principles as alternatives.

3. a. Incorrect. The principle that the organization selects, develops, and performs ongoing and/or separate evaluations to ascertain whether the components of internal control are present and functioning underlies the monitoring activities component of internal control.
   b. Incorrect. The principle that the organization obtains or generates and uses relevant, quality information to support the functioning of other components of internal control underlies the information and communication component of internal control.
   c. Incorrect. The principle that the organization identifies and assesses changes that could significantly impact the system of internal control underlies the risk assessment component of internal control.
   d. Correct. The principle that management establishes, with board oversight, structures, reporting lines, and appropriate authorities and responsibilities in pursuit of objectives underlies the control environment component of internal control.
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Quizzer Questions: Module 1

1. Which of the following statements best characterizes independence of mind, according to the Yellow Book?

   a. The absence of circumstances that would cause a reasonable third party to believe that the professional skepticism of a member of the audit team had been compromised
   b. The individual auditor’s freedom from personal bias
   c. A state of mind permitting the auditor to perform the audit without being affected by influences that compromise professional judgment
   d. The individual auditor’s and the audit team’s freedom from self-interest

2. According to the Yellow Book, self-review constitutes a threat to independence because:

   a. Financial or other interest may have inappropriate influence on auditor judgment.
   b. External pressures may affect the auditor’s ability to make independent and objective judgments.
   c. The auditor may perform management functions on behalf of the audited entity.
   d. Nonaudit services provided by the auditor or audit organization may not receive appropriate evaluation as a part of the audit.

3. The Yellow Book lists which of the following as a safeguard at the audited entity that the auditor may place limited reliance in to eliminate or reduce a threat to independence?

   a. A requirement that auditor appointment be approved by persons outside of management
   b. Removal from the audit team of an individual whose relationships create a threat to independence
   c. Review of audit work by a professional staff member of the audited entity
   d. Contracting another audit organization to reperform part of the audit
4. A threat to independence is considered unacceptable under all of the following circumstances except:
   a. The threat affects the auditor’s ability to conduct the audit free from influences that compromise professional judgment.
   b. The threat exposes the auditor to circumstances in which informed and reasonable third parties would conclude that the auditor’s objectivity had been compromised.
   c. The threat raises a public perception that the audit organization’s integrity might possibly become compromised.
   d. The threat exposes the audit organization to circumstances in which a reasonable and informed third party would conclude that its ability to conduct the audit with appropriate professional skepticism was impaired.

5. The independence standard in Government Auditing Standards applies to auditors in government entities:
   a. Only when they report to third parties externally
   b. Only when they report to senior management within the audited entity
   c. Whether they report to third parties externally or to senior management within the audited entity
   d. Whether they are in the same or a different branch of government than the audited entity

6. Which of the following statements best applies to the auditor’s determination of whether nonaudit services create a threat to independence?
   a. The auditor should obtain assurance that the person designated to oversee those services has the expertise to perform those services.
   b. The auditor should obtain assurance that management assumes all management responsibilities for those services.
   c. The auditor should accept responsibility for the results of those services.
   d. The auditor should obtain the approval of those charged with governance before accepting an engagement to provide nonaudit services.
7. Auditors are prohibited from performing all of the following activities for an audited entity except:

   a. Accepting responsibility for the design of internal control
   b. Serving as a voting member of the entity’s board of directors
   c. Reporting to those charged with governance on behalf of management
   d. Providing advice on an accounting matter as an ancillary part of the audit

8. Provided that certain conditions are met, auditors may perform which of the following nonaudit services?

   a. Authorizing the audited entity’s transactions
   b. Posting transactions that have been coded by management to the general ledger
   c. Making changes to the general ledger without management’s approval
   d. Maintaining bank accounts for the audited entity

9. Which of the following activities pose a threat to the independence of an external auditor that could possibly be eliminated or reduced to an acceptable level by applying the safeguards envisioned in Government Auditing Standards?

   a. Proposing adjusting journal entries, provided that management reviews and accepts the entries, and understands their impact and nature
   b. Providing valuation services that involve a significant degree of subjectivity
   c. Supervising ongoing internal control monitoring procedures on management’s behalf
   d. Setting internal audit policies or strategic direction for the audited entity

10. Government Auditing Standards requires documentation of all of the following except:

    a. How safeguards that have been applied mitigate or eliminate threats to independence
    b. Threats to independence that rise to an unacceptable level
    c. Limitations on nonaudit services
    d. Certain specific safeguards pertaining to audit organizations located within a government entity that are not considered to be independent
11. Each of the following statements about the auditor’s responsibilities with respect to instances of fraud, noncompliance or abuse is correct except:

   a. It may sometimes be appropriate for auditors to withdraw from an audit to avoid interference with an investigation or legal proceeding.
   b. Law or regulation may require auditors to report certain types of fraud, noncompliance or abuse to law enforcement authorities before performing additional audit procedures.
   c. It is not appropriate for auditors to work with investigators or legal authorities on investigations involving potential fraud.
   d. Auditors are required to evaluate the impact of legal proceedings or investigations on the current audit.

12. Each of the following statements applies to elements of a finding except:

   a. The condition element of a finding is used to demonstrate the need for corrective action.
   b. Factors accounting for the differences between the criteria and the condition include poorly designed policies or procedures.
   c. The criteria for a finding consist of such things as laws and regulations, contracts or grant agreements, standards, and expected performance.
   d. President’s Council on Integrity and Efficiency noted that missing audit finding information was a common deficiency in audits.

13. In a GAGAS audit, auditors should comply with which of the following documentation requirements, in addition to the requirements of GAAS?

   a. Document the auditor’s risk assessment down to the relevant assertion level.
   b. Obtain management representations as of the date of the auditor’s report.
   c. Complete the assembly of the audit documentation file within thirty days of the report release date.
   d. Document, prior to the report release date, supervisory review of evidence supporting the findings, conclusions and recommendations in the audit report.
14. Which of the following is a requirement related to reporting under GAGAS?

a. Auditors should cite compliance with GAAS in a GAGAS report.
b. When auditors report separately on internal control over financial reporting and on compliance, they should state that the additional reports are an integral part of a GAGAS audit.
c. Public accounting firms engaged to perform GAGAS audits should not assume report distribution responsibilities.
d. Auditors should obtain the views of responsible officials of the audited entity concerning findings, conclusions, recommendations and corrective actions in writing.

15. Auditors should report instances of known or likely fraud, noncompliance or abuse directly to outside parties under which of the following circumstances?

a. After the auditors have been dismissed or have resigned, unless otherwise prohibited by law or regulation.
b. When the audited entity’s management fails to make communications to external parties that are required by law or regulation, and prior to the auditor communicating the failure to those charged with governance.
c. When the audited entity’s management fails to take timely and appropriate action to respond to known noncompliance, and the auditors have first communicated the failure to those charged with governance.
d. After they have received confirmation from external parties that the audited entity’s management has properly reported the fraud, noncompliance or abuse.

16. Which of the following statements best applies to the term validity, as it relates to evidence in a performance audit?

a. It is comparable to the term “materiality” as it applies to financial audits.
b. It is the extent to which the evidence provides a reasonable or meaningful basis for measuring what is being evaluated.
c. It is the relative importance of the evidence within the context in which it is being considered.
d. It is the extent to which evidence has importance to the issue being addressed.
17. Which of the following is required of auditors with respect to abuse?

a. To apply procedures to ascertain the potential effect of instances of abuse coming to their attention that could be quantitatively or qualitatively significant
b. To assess the risks that significant abuse could occur
c. To discuss risk of abuse among audit team members
d. To identify provisions of laws, regulations, contracts, or grant agreements that are subject to abuse

18. When the identities of those charged with governance are not readily apparent, auditors:

a. Should communicate an overview of the audit’s objectives, scope, methodology, timing, and planned reporting to the cognizant legislative committee
b. Should document their processes and conclusions for determining who should receive required audit communications
c. May omit otherwise required auditor communications if, in their professional judgment, it is appropriate to do so
d. May direct required auditor communications to the audited entity’s management

19. Each of the following statements applies to elements of a finding in a performance audit except:

a. The President’s Council on Integrity and Efficiency noted that missing audit finding information was a common deficiency in audits conducted under the Single Audit Act.
b. The effect identifies the outcomes or consequences of the condition.
c. Factors accounting for the differences between the criteria and the condition include inconsistent, incorrect, or incomplete implementation.
d. The criteria for a finding consist of such items as laws and regulations, contracts or grant agreements, standards, and expected performance.
20. Which of the following is an unconditional requirement with respect to audit documentation in a performance audit?

a. The planning, conducting, and reporting of each audit must be documented.
b. The audit documentation must contain sufficient detail to enable an experienced auditor having no previous connection with the audit to understand the nature, timing, and extent of audit procedures performed.
c. The audit documentation must contain copies of documents examined.
d. Auditors must document supervisory review, after report issuance but prior to the close of the documentation completion period, of evidence that supports the audit’s findings, conclusions, and recommendations.

21. When reporting on internal control deficiencies that are not significant to the audit objectives but that still merit the attention of those charged with governance:

a. Auditors must report the deficiencies in the audit report.
b. Auditors must report the deficiencies in a separate written communication.
c. Auditors may elect to report the deficiencies orally.
d. Auditors should report the deficiencies either in the audit report or in a separate written communication.

22. Auditors should not report known noncompliance directly to outside parties unless:

a. They have been dismissed from the audit.
b. The audited entity’s management refuses to provide timely written comments on the noncompliance.
c. The audited entity’s management has not made communications to external parties that are required by law or regulation, and the auditors have first communicated this failure to those charged with governance.
d. External parties have confirmed that the audited entity’s management has properly reported the noncompliance.
23. When the views of responsible officials on the audit’s recommendations do not adequately address those recommendations, the auditors should:

a. Explain their disagreements in the audit report
b. Decline to issue a report on the audit
c. Revise their report
d. Provide an oral evaluation to those charged with governance

24. When pertinent information is prohibited from public disclosure, or is excluded from the auditor’s report due to its confidential or sensitive nature, all of the following apply except:

a. The auditor may issue a separate, limited-use or classified report containing classified information or information that is otherwise prohibited by law or regulation from general disclosure.
b. The auditor should disclose in the report that certain information has been omitted.
c. The auditor should only report such information orally.
d. The auditor should disclose in the report the reason or other circumstances that make the omission necessary.

25. Each of the following is a requirement related to report distribution in a performance audit, except:

a. A public accounting firm engaged to perform a GAGAS audit should clarify report distribution responsibilities with the engaging organization.
b. If a public accounting firm is responsible for report distribution, it should obtain an agreement about which organizations or officials are to receive the report.
c. Auditors should document any limitations on report distribution.
d. Audit organizations in government should make reports publicly available by posting them on a website or through other transparency mechanisms.
26. Which of the following is a responsibility of an accountant that should be addressed in the accountant’s review report?
   
   a. Performing procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements
   b. Implementing internal controls relevant to the preparation of the financial statements
   c. Maintaining internal controls relevant to the fair presentation of the financial statements
   d. Preparing the financial statements in accordance with accounting principles generally accepted in the United States

27. Each of the following is a responsibility of management that should be addressed in the understanding with the client except:

   a. Designing internal controls relevant to the preparation of the financial statements
   b. Identifying and ensuring compliance with laws and regulations applicable to the client’s activities
   c. Assuring that the engagement is conducted in accordance with SSARS
   d. Fraud prevention

28. The required representations in a review engagement should address or contain management’s:

   a. Belief that the financial statements are fairly presented
   b. Comments on significant variances between actual and expected financial statement data
   c. Reliance on the accountant for the preparation of the financial statements
   d. Reliance on the accountant for the detection of fraud

29. SSARS 19 requires that the representation letter in a review engagement be dated:

   a. No earlier than the date of the accountant’s report
   b. As of the last date of field work
   c. No later than the date of the accountant’s report
   d. As of the date of the accountant’s review report
30. Properly documented analytical procedures usually contain all of the following except:

a. Follow-up procedures on variances, usually in the form of inquiries of management
b. Additional evidence to corroborate management’s responses to review inquiries
c. Documentation of the accountant’s expectations for comparisons of actual data or relationships to data developed by the accountant
d. Comments on significant variances of actual data from expectations

31. All of the following statements apply to the principles set forth in the preface to the new Codification of Statements on Auditing Standards except:

a. These principles provide a framework that is useful in understanding and explaining an audit.
b. These principles are organized to provide a structure for the new codification of auditing standards.
c. These principles address auditor actions in performing the audit.
d. These principles are unconditional requirements of professional standards.

32. Which of the following is one of the premises upon which an audit is conducted?

a. The auditor is responsible for drafting the financial statement disclosures.
b. Management is responsible for providing the auditor with the information needed to conduct the audit.
c. An audit constitutes part of the entity’s internal control over financial reporting.
d. Management is responsible for assuring that the auditor possesses the appropriate competence to perform the audit.

33. Each of the following is a responsibility of the auditor except:

a. Maintaining professional skepticism throughout the audit.
b. Preparing the financial statements in accordance with the applicable financial reporting framework.
c. Exercising professional judgment throughout the audit.
d. Having appropriate capabilities to perform the audit.
34. Which of the following statements best describes *reasonable assurance* as it is used in the preface?

- a. Reasonable assurance is a high, but not absolute, level of assurance.
- b. Obtaining reasonable assurance has no relationship to the cost-benefit considerations in conducting an audit.
- c. Reasonable assurance is attainable only when the inherent limitations of financial reporting can be overcome.
- d. Reasonable assurance includes assurance that the financial statements are free from all errors.

35. In expressing an opinion on financial statements, the principles state that the auditor does all of the following *except*:

- a. Renders a written report
- b. Bases that opinion on an evaluation of the audit evidence obtained
- c. States that an opinion cannot be expressed when there are departures from the applicable financial reporting framework
- d. States whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework

36. When the FASB ASC does *not* contain guidance for an event or transaction, an entity should first consider:

- a. Practices that are widely recognized in the industry
- c. Technical Information Service Inquiries and Replies included in AICPA Technical Practice Aids
- d. Accounting principles for similar events or transactions in the FASB ASC

37. Each of the following statements applies to the hierarchy of AICPA Professional Standards *except*:

- a. Practitioners should be prepared to explain how they fulfilled the requirements of the Standards when they have not applied the guidance in the “interpretive publications.”
- b. “Interpretive publications” have no authoritative status, but they may help practitioners understand and apply the Standards.
- c. The AICPA *Code of Professional Conduct* requires practitioners to comply with the Standards.
- d. Practitioners may presume that “other publications” published by the AICPA that have been reviewed by its Audit and Attest Standards staff are appropriate.
38. Which of the following represents authoritative literature for audits of nonpublic entities?

a. The AICPA Audit and Accounting Manual  
   b. The AICPA Codification of Statements on Auditing Standards  
   c. Auditing guidance contained in AICPA Audit and Accounting Guides  
   d. AICPA Auditing Statements of Position (SOP) in Technical Practice Aids

39. Attestation Interpretations include which of the following?

a. Appendixes to the SSAEs  
   b. AICPA Alerts  
   c. Attestation articles in the AICPA's *CPA Letter*  
   d. AICPA White papers

40. Of the following, which item is at the highest level of guidance for compilation and review engagements?

a. Technical Questions and Answers contained in the AICPA *Technical Practice Aids*  
   b. AICPA continuing professional education programs  
   c. Compilation and review interpretations of SSARS  
   d. Compilation and review publications from State CPA societies

41. When prepaid expenses are considered to be at low risk of material misstatement, sufficient appropriate audit evidence might be most efficiently obtained by:

a. Comparing the prepaid balances to prior period balances and to the related current period expenses, and following up on any unexpected relationships noted  
   b. Vouching disbursements to vendors’ invoices and recalculating amortization  
   c. Confirming disbursements with vendors  
   d. Making inquiries of management as to the nature of the prepaid expenses
42. Which of the following characteristics, according to this course, is often associated with the use of free-form narrative memoranda to document risk assessment?

a. Narrative memoranda may encourage staff to think of risk assessment within narrow limits that are inappropriate to the circumstances of the engagement.

b. Because of their open-ended nature, narrative memoranda may require more experience to complete than a structured questionnaire or fill-in-the-blank–type document.

c. Narrative memoranda are difficult to roll forward from one year to the next.

d. Narrative memoranda may encourage staff to include details that are irrelevant to the risk assessment.

43. When an auditor makes a material adjustment to the financial statements:

a. There should normally be a documented evaluation to determine whether it indicates a significant deficiency or material weakness in internal control.

b. A written communication to management concerning a material weakness in internal control is mandatory.

c. Evaluation of the internal control implications of the adjustment is not usually necessary.

d. It is considered a best practice to inform those charged with governance immediately.

44. When the contents of internal control documentation are not adequately considered in the risk assessment process:

a. Inefficiencies in the design of further audit procedures normally result.

b. Ineffective further audit procedures are likely to be designed and applied.

c. The overall assessment of the risk of material misstatement can be inconsistent with the assessed level of control risk.

d. An inappropriately low level of risk will result for the assessment of the overall risk of material misstatement.
45. According to this course material a failure to evaluate, or incorrectly evaluating, control deficiencies may result in which of the following consequences?

a. Those charged with governance will not be adequately informed about audit findings.

b. Management’s written representations to the auditor will be insufficient.

c. The firm will fail its peer review.

d. Management may not remedy control deficiencies that exist.

46. All of the following statements apply to the auditor’s communication with those charged with governance except:

a. That communication should be documented when it is made orally.

b. That communication must be written.

c. That communication should include the planned scope and timing of the audit.

d. That communication should include the auditor’s views about qualitative aspects of significant accounting policies and practices.

47. All of the following are attributes of the new auditor’s report except:

a. It may refer to another document that elaborates upon management’s responsibility.

b. It contains paragraphs that discuss the auditor’s responsibility as contrasted with management’s.

c. It contains distinct paragraph headings.

d. It contains headings that separate the report on the financial statements from the report on the other legal or regulatory requirements, when such are present.

48. Which of the following statements best applies to the auditor’s determination of whether to rely on evidence obtained as a result of reviewing the predecessor auditor’s work?

a. The current auditor is entitled to rely on the predecessor’s work absent evidence to the contrary.

b. The current auditor is not allowed to rely on the predecessor’s work.

c. The current auditor’s reliance on the predecessor’s work is influenced by his or her assessment of the predecessor’s professional competence.

d. The current auditor is required to rely on the predecessor’s work.
49. All of the following may be acceptable practices for establishing and maintaining the QC system of a small, local auditing firm except:

a. Writing a custom QC document following the elements prescribed in the PRM
b. Customizing a QC document from an appropriate illustrative QC document in the firm’s third-party practice aids by tailoring it to the firm’s specific practice needs
c. Using the QC policies and procedures questionnaire in the PRM, supplemented with brief narratives
d. Relying on an informal, orally communicated system of long-standing policies within the firm.

50. Which of the following would most likely be an appropriate EQCR criterion for a mid-sized firm with a diversified audit and accounting practice?

a. All full-disclosure financial statement engagements
b. Only those engagements that in the engagement partner’s judgment should be subjected to EQCR
c. All audit engagements
d. Audit engagements exhibiting unusual risk characteristics for the firm’s practice, including initial audit engagements and engagements involving going-concern issues
Quizzer Questions: Module 3

51. SAS 124 applies in all of the following situations except:
   a. The foreign GAAP financial statements are intended solely for use inside the United States.
   b. The foreign GAAP financial statements have been prepared in accordance with a jurisdictional variation of IFRS.
   c. The foreign GAAP has not been adopted by a body designated by the AICPA Council to establish accounting principles.
   d. The foreign GAAP financial statements have been prepared in accordance with IFRS.

52. When there are significant differences between foreign and U.S. GAAP, auditors might conclude that:
   a. The foreign GAAP is not a fair presentation framework.
   b. It would be unethical to accept an engagement to report on the foreign GAAP statements.
   c. It would be inappropriate to accept an engagement to report on foreign GAAP statements that are intended for wide public distribution in the United States.
   d. The auditor’s report should be qualified for departures from U.S. GAAP.

53. When auditors plan to use the form and content of another country’s auditor’s report, they should be aware of all of the following except:
   a. They may be required to report on statutory compliance.
   b. They must also issue a report with the form and content required by U.S. GAAS.
   c. An understanding of local laws and regulations may be required.
   d. The auditors’ report of the other country may convey different meanings than U.S. auditors’ reports, even when it appears to be similar.
54. In an engagement to audit statements prepared under a foreign GAAP that includes a requirement to apply the GAAS of the foreign country, the auditor should apply:

   a. Both the foreign GAAS and either the ISAs or U.S. GAAS, as applicable
   b. The foreign GAAS only
   c. Both the foreign GAAS and U.S. GAAS, including requirements related to the form and content of the report
   d. Both the foreign GAAS and U.S. GAAS, except for requirements related to the form and content of the report

55. Which of the following statements best describes the auditor’s responsibilities in reporting on foreign GAAP statements that are intended to be used solely outside of the United States?

   a. The auditor must use the report form and content of the foreign country.
   b. The auditor must use a U.S. form of report that reflects that the statements have been prepared in accordance with a foreign GAAP.
   c. The auditor should use the report form and content prescribed by the ISAs.
   d. The auditor may use either the report form and content of the foreign country, or if applicable, the ISAs, or the U.S. form of report that reflects that the statements have been prepared in accordance with a foreign GAAP.

56. Which of the following items is considered *required supplementary information*?

   a. Schedule of Expenditures of Federal Awards in an audit under OMB Circular A-133
   b. Financial ratios
   c. Common Interest Realty Association replacement reserve schedule
   d. Management discussion and analysis accompanying the financial statements

57. All of the following are considered *supplementary information* except:

   a. Consolidating information
   b. Historical summaries of items extracted from the basic financial statements
   c. Additional details or explanations of items in or related to the basic financial statements
   d. Reports on operations by those charged with governance
58. Which of the following circumstances would preclude an auditor from expressing an opinion on supplementary information?
   
a. An adverse opinion or a disclaimer of opinion on the financial statements has been issued.
b. The audited financial statements are posted on the entity’s Web site, when the supplementary information does not accompany them.
c. The auditor’s report on the financial statements contains an “emphasis of a matter” paragraph.
d. The supplementary information covers the same period as the financial statements.

59. When the auditor’s opinion on the basic financial statements is qualified, and that qualification affects the supplementary information:
   
a. The auditor should restrict the use of the report on the supplementary information to appropriate specified parties to preclude misunderstanding of the supplementary information
b. The auditor may not express an opinion on the supplementary information
c. The auditor’s report on the supplementary information should also be qualified
d. The auditor must withhold the report on the supplementary information

60. Which of the following statements best applies to the auditor’s reporting responsibility when required supplementary information is omitted from the presentation of audited financial statements?
   
a. Omission of required supplementary information should cause the auditor to disclaim an opinion on the basic financial statements.
b. If management declines to present required supplementary information, the auditor should withdraw from the engagement.
c. The auditor may elect to disclose the omission of required supplementary information in an explanatory paragraph following the opinion paragraph in the report on the basic financial statements.
d. If management declines to present required supplementary information, the auditor has no obligation to present such information.
61. When material departures from the prescribed guidelines have been identified by the auditor in required supplementary information, the explanatory paragraph should contain which of the following?

a. A description of the material departures from the prescribed guidelines
b. A statement modifying auditor’s opinion on the basic financial statements because of the material departures
c. A statement that there are doubts about whether material modifications should be made to the required supplementary information in order for it to be presented in accordance with prescribed guidelines
d. A disclaimer of opinion on the required supplementary information

62. Under the requirements of SAS 118 for reporting on other information in documents containing audited financial statements, auditors are required to:

a. Disclaim an opinion on other information in an explanatory paragraph to the auditor’s report on the financial statements
b. Report on other information
c. Withhold their reports on the financial statements when uncorrected material misstatements of fact are identified
d. Consider the effects of material inconsistencies or misstatements of fact on the financial statements and the related auditor’s report
63. All of the following statements apply to the accountant’s reporting responsibilities for *required supplementary information* in a compilation engagement *except*:

a. SSARS 19 contains reporting requirements for situations in which basic financial statements are accompanied by required supplementary information.

b. When the required supplementary information is presented and the accountant did not compile it, the compilation report may contain an explanatory paragraph stating, among other things, that the accountant has not audited, reviewed, nor compiled that information and, accordingly does not express an opinion or provide any assurance on it.

c. An interpretation to SSARS 19 describes how the accountant may modify the standard compilation report by including a separate paragraph that refers to the required supplementary information and explains the circumstances regarding its presentation.

d. An interpretation to SSARS 19 provides example wording for an explanatory paragraph in the compilation report when material departures from prescribed guidelines were noted while compiling the required supplementary information.

64. All of the following statements are required to be included in the accountant’s report, or in a separate report, when reviewed basic financial statements are accompanied by supplementary information *except*:

a. The review was made for the purpose of expressing a conclusion that there are no material modifications that should be made to the financial statements in order for them to be in conformity with the applicable financial reporting framework.

b. The other data accompanying the financial statements, although not a part of the basic financial statements, is required by [*identify the designated accounting standard setter, such as the FASB or GASB*], which considers it to be an essential part of financial reporting.

c. The other data accompanying the financial statements are presented only for purposes of additional analysis.

d. The degree of responsibility, if any, that the accountant is taking with respect to the supplementary information.
65. When required supplementary information accompanies the basic financial statements, an interpretation to SSARS 19 states that the accountant may modify the standard review report by including a separate paragraph referring to the required supplementary information. All of the following statements apply to that paragraph except:

a. It follows the paragraph that reports the results of the engagement.

b. It states that the accountant has reviewed the required supplementary information.

c. When the required supplementary information is included, but not audited, reviewed, or compiled by the accountant, this paragraph contains the same wording as the similar paragraph for compilation reports.

d. When all the required supplementary information is omitted, this paragraph contains a sentence stating that the results of the review of the basic financial statements are not affected by the missing information.

66. AU-C section 930, *Interim Financial Information*, is inapplicable under which of the following conditions?

a. The most recent annual financial statements have been audited by the auditor.

b. The interim financial information and the annual financial statements have been prepared under differing financial reporting frameworks.

c. The auditor has audited the latest annual financial statements, and when the current year statements will be audited, another auditor has not been engaged to audit them prior to the beginning of the period covered by the review.

d. If the interim information contains condensed financial statements, those condensed statements accompany the latest audited financial statements, or the audited statements are made readily available.
67. Which of the following characteristics is associated with a review of interim financial information?

a. A review of interim financial information ordinarily includes obtaining evidence to corroborate the responses to inquiries.
b. A review of interim financial information provides a basis for expressing an opinion on that information.
c. A review of interim financial information consists principally of performing analytical procedures and inquiries.
d. A review of interim financial information provides reasonable assurance about internal control.

68. All of the following attributes comprise a part of the definition of “interim financial information” except:

a. It may cover a period or periods less than a full year.
b. It must comprise a complete set of financial statements.
c. It may cover a 12-month period ending on a date other than the entity’s fiscal year end.
d. It is prepared and presented in accordance with an applicable financial reporting framework.

69. All of the following should cause an auditor to decline an engagement under this standard except:

a. Management does not agree to provide unrestricted access to persons within the entity of whom the auditor determines it necessary to make inquiries.
b. The auditor has determined that the financial reporting framework is not acceptable.
c. Management intends to include the auditor’s review report in a document containing the interim financial information that indicates it has been reviewed by the auditor.
d. Management requires that an oral understanding be the sole agreement for the performance of the engagement.

70. To plan and conduct a review of interim financial information, auditors should:

a. Decide whether condensed financial statements will be presented
b. Test accounting records through observation or inspection
c. Perform “walk-throughs” of internal controls relating to the preparation and fair presentation of interim financial information
d. Have an understanding of the entity and its environment
71. Any of the following procedures might normally be applied in a review of interim financial information except:

   a. Comparing the gross profit percentage of the current interim period with that of the immediately preceding interim period
   b. Considering the relationship between gross sales in dollars and units of product sold
   c. Confirming significant accounts receivable
   d. Comparing key ratios of the current period with industry-wide data

72. The auditor’s inquiries in a review of interim financial information ordinarily include all of the following except:

   a. Written inquiries of the client’s legal counsel
   b. Significant new related party transactions
   c. Significant journal entries and other adjustments
   d. Communications from regulators

73. In a review of interim financial information, the auditor’s communication with those charged with governance:

   a. Should be in writing
   b. Must report on all detected instances of fraud
   c. Should include any modifications made to the interim financial information
   d. Should be documented

74. The standard form of the auditor’s review report on interim financial information should contain all of the following elements except:

   a. A title that includes the word “independent”
   b. A section captioned “Management’s Responsibility”
   c. A section captioned “Auditor’s Responsibility”
   d. An opinion paragraph
75. Which of the following statements best describes a reporting provision under this standard?

   a. The auditor’s report on review of interim financial information should contain a statement to the effect that the review is substantially less in scope than an audit conducted in accordance with U.S. GAAS.

   b. When interim financial information that is presented as a note to audited financial statements is not marked as unaudited, the auditor should issue a qualified opinion on that information in the audit report on the financial statements.

   c. When a condensed balance sheet derived from audited statements is presented on a comparative basis with the interim financial information, auditors may apply limited procedures to form a basis for reporting on that condensed balance sheet.

   d. When interim financial information accompanies audited financial statements, the auditor should include an emphasis-of-matter paragraph in the auditor’s report on the audited statements.
Quizzer Questions: Module 4

76. The requirements of Reporting on Compliance with Contractual Agreements or Regulatory Requirements apply under which of the following circumstances?

   a. A lender requests an auditor, in connection with an audit of an entity’s financial statements, to report on compliance with certain covenants of the loan agreement relating to accounting matters.

   b. An auditor is engaged to report on compliance and other matters based on an audit of financial statements in accordance with Government Auditing Standards.

   c. An auditor is engaged to report on compliance with requirements that could have a direct and material effect on major programs and on internal control over compliance in accordance with OMB Circular A-133.

   d. An entity requests an auditor to perform a separate attest engagement on the effectiveness of its internal control over compliance with specified regulatory requirements.

77. All of the following are attributes of a compliance report under this standard except:

   a. The compliance report describes any instances of noncompliance that are identified.

   b. The compliance report expresses an opinion on compliance with specified aspects of contractual agreements or regulatory requirements insofar as they relate to accounting matters.

   c. The compliance report is in writing.

   d. The compliance report is dated as of the evidence completion date of the audit of the financial statements.

78. When an auditor has expressed an adverse opinion or a disclaimer on the financial statements:

   a. The auditor must express an adverse opinion or a disclaimer, as appropriate, on compliance.

   b. A report on compliance should be issued only when instances of noncompliance are identified.

   c. A report on compliance should not be issued.

   d. The auditor may, if appropriate, issue a report stating that no instances of noncompliance were identified.
79. A separate compliance report:
   a. Should not imply that the financial statements were audited in accordance with U.S. GAAS.
   b. May contain a paragraph that includes an appropriate alert restricting the use of the report.
   c. Should be dated within 45 days of the date of the auditor’s report on the financial statements.
   d. May also communicate a matter contained in an emphasis-of-matter paragraph in the auditor’s report on the financial statements that are modifications to the auditor’s opinion.

80. A combined compliance report should:
   a. Be issued only when the auditor’s opinion on the financial statements is unmodified
   b. Contain a statement that the audit was directed toward obtaining knowledge regarding compliance
   c. State that the report is being provided in connection with the audit of the financial statements
   d. Not address management’s interpretations of the contractual or regulatory requirements

81. Which of the following statements best applies to the effective date of the new *Codification of Statements on Auditing Standards (Clarified)*?
   a. Early implementation of its provisions is permitted.
   b. It is effective for audits of financial statements for periods beginning on or after December 15, 2012.
   c. It is generally effective starting with calendar year 2012 year-end audits.
   d. It is effective only for audits conducted under the *International Auditing Standards*. 
82. All of the following statements apply to the new *Codification* **except:**

a. The new *Codification* contains a preface that sets forth broad philosophical principles underlying an audit conducted in accordance with GAAS.

b. AU-C Section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, contains conceptual principles that shape the overall objectives of an audit and broad, overarching requirements that govern the conduct of an audit.

c. The new *Codification* moves U.S. GAAS toward a more specifically rules-based system.

d. The new *Codification* contains a master glossary that gives definitions of terms used throughout GAAS.

83. All of the following statements apply to the clarified standards **except:**

a. The clarified standards adopt a uniform format for each standard that is similar to that of the *International Auditing Standards*.

b. The clarified standards adopt substantially all of the substantive requirements of *International Auditing Standards* for each applicable standard.

c. Each clarified standard contains a separate section that lists all of its requirements.

d. Auditors should read and understand the entire text of the *Application and Other Explanatory Material* section of each clarified standard, and should be prepared to justify departures from it in their work.

84. Each of the following represents a significant change from previous audit practice that is effective with the new *Codification* **except:**

a. The clarified standards no longer require written confirmations.

b. The clarified standard for compliance with laws and regulations requires auditors to perform procedures to identify instances of noncompliance with laws and regulations that may materially affect the financial statements, including inspection of correspondence with regulators.

c. Special purpose frameworks are limited to cash, tax, regulatory, or contractual bases of accounting.

d. Direct written communication with the client’s legal counsel is required only when the auditor assesses a risk of material misstatement concerning litigation or claims, or when audit procedures indicate that material litigation or claims may exist.
85. Which of the following statements applies to the new reporting requirements under the clarified standards?

a. The auditor is precluded from covering other legal or regulatory requirements in the audit report on the financial statements.
b. The new auditor’s report contains required paragraph headings for management’s responsibility for the financial statements, the auditor’s responsibility, and the auditor’s opinion.
c. *Emphasis-of-matter* paragraphs, when included, are required to precede the opinion paragraph.
d. An *emphasis-of-matter* paragraph in the auditor’s report refers to a matter that is not presented or disclosed in the financial statements that in the auditor’s judgment is relevant to the users’ understanding of the audit, the auditor’s responsibilities or auditor’s report.

86. The new auditor’s report:

a. Includes a description of the potential effects of material weaknesses in internal control
b. Is optional in the first year of the transition period
c. Is required starting with calendar year 2013 year-end audits
d. Expands upon the auditor’s responsibility and contrasts it with management’s responsibility in the audit

87. Almost all audits will be affected by changes in which of the following?

a. Audits of group financial statements
b. Disclosures of segment information
c. Using the work of an auditor’s specialist
d. The content of the engagement letter

88. This course recommends all of the following as a part of a program for implementing the new standards *except*:

a. Assure that the most current edition of any third-party practice aids that the firm relies upon is available to, and placed in use by audit staff
b. Designate a persons or persons as implementation experts and make them available for consultation
c. Adopt a primarily “learn-as-you-go” approach to implementation
d. Budget for additional supervisory time in the initial round of audits under the new standards
89. In designing education and training programs to inform firm personnel about the new standards, this course recommends all of the following measures except:

- **a.** Using multiple instructional modalities
- **b.** Adapting instructional materials created by third parties to the firm’s unique circumstances
- **c.** Beginning training well in advance of the first anticipated implementation
- **d.** Conducting all training in one concentrated session

90. When firms communicate with audit clients regarding implementation of the new standards, they should advise the clients:

- **a.** To expect more questions regarding the legal and regulatory framework
- **b.** That the firm’s internal control letter will now include a quantification of the potential effects of significant deficiencies or material weaknesses in internal control
- **c.** To expect the engagement letter to contain a detailed description of significant changes in management’s responsibilities for the audit
- **d.** That cash and tax bases of accounting are no longer permissible

91. Which of the following statements best describes an objective of internal control?

- **a.** Internal control relates only to the internal aspects of reporting.
- **b.** Internal control relates solely to financial performance goals.
- **c.** Internal control relates to the performance expectations of external parties.
- **d.** Internal control relates to adherence to applicable laws and regulations.

92. All of the following statements apply to the updated Framework except:

- **a.** The updated Framework has made explicit the five components that were implicit in the original Framework.
- **b.** Auditors can use the principles and attributes to help them assess their clients’ internal control over financial reporting.
- **c.** The attributes are characteristics associated with each of the principles.
- **d.** The principles can be considered as similar to important control objectives.
93. Before risk can be assessed, management must:
   a. Consider various ways in which fraud can occur
   b. Determine how to respond to risks
   c. Consider the impact of possible changes within its own business model that may render internal control ineffective
   d. Select and develop general control activities over technology

94. Control activities may include any of the following except:
   a. Business performance reviews
   b. Reconciliation
   c. Approvals
   d. Capturing internal and external sources of data

95. In performing monitoring activities to ascertain whether the components of internal control are present and functioning, the organization:
   a. Uses both ongoing and separate evaluations
   b. May consider a mix of ongoing and separate evaluations
   c. Must use separate evaluations
   d. Must use ongoing evaluations
Module 1: Answer Sheet

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STREET _______________________________________________________________________________

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BUSINESS PHONE NUMBER _____________________________________________________________

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1. ___  8. ___  14. ___  20. ___
2. ___  9. ___  15. ___  21. ___
3. ___  10. ___  16. ___  22. ___
4. ___  11. ___  17. ___  23. ___
5. ___  12. ___  18. ___  24. ___
6. ___  13. ___  19. ___  25. ___
7. ___

Please complete the Evaluation Form (located after the Module 4 Answer Sheet) and return it with this Quizzer Answer Sheet to CCH at the address on the previous page. Thank you.
TOP AUDITING ISSUES FOR 2013 CPE COURSE

Module 2: Answer Sheet

NAME ________________________________________________________________________________

COMPANY NAME ______________________________________________________________________

STREET _______________________________________________________________________________

CITY, STATE, & ZIP CODE __________________________________________________________________

BUSINESS PHONE NUMBER ______________________________________________________________

E-MAIL ADDRESS _______________________________________________________________________

DATE OF COMPLETION _________________________________________________________________

Please go to CCHGroup.com/PrintCPE to complete your Quizzer online for instant results and no Express Grading Fee. A $60.00 processing fee will be charged for each user submitting Module 2 for grading.

If you prefer to mail or fax your Quizzer, remove both pages of the Answer Sheet from this book and return them with your completed Evaluation Form to: CCH Continuing Education Department, 4025 W. Peterson Ave., Chicago, IL 60646-6085 or fax your Answer Sheet to CCH at 773-866-3084. You must also select a method of payment below.

METHOD OF PAYMENT:

☐ Check Enclosed  ☐ Visa  ☐ Master Card  ☐ AmEx

☐ Discover  ☐ CCH Account*  ________________________________

Card No. ________________________________  Exp. Date  ________________________________

Signature ____________________________________________________________________________

EXRESS GRADING: Please fax my Course results to me by 5:00 p.m. the business day following your receipt of this Answer Sheet. By checking this box I authorize CCH to charge $19.00 for this service.

☐ Express Grading $19.00  Fax No.  ________________________________

* Must provide CCH account number for this payment option

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a Wolters Kluwer business
Module 2: Answer Sheet

Please answer the questions by indicating the appropriate letter next to the corresponding number.

26.  
33.  
39.  
45.  

27.  
34.  
40.  
46.  

28.  
35.  
41.  
47.  

29.  
36.  
42.  
48.  

30.  
37.  
43.  
49.  

31.  
38.  
44.  
50.  

32.  

Please complete the Evaluation Form (located after the Module 4 Answer Sheet) and return it with this Quizzer Answer Sheet to CCH at the address on the previous page. Thank you.
TOP AUDITING ISSUES FOR 2013 CPE COURSE  (4590-3)

Module 3: Answer Sheet

NAME ________________________________________________________________________________
COMPANY NAME ______________________________________________________________________
STREET _______________________________________________________________________________
CITY, STATE, & ZIP CODE _____________________________________________________________________
BUSINESS PHONE NUMBER ______________________________________________________________
E-MAIL ADDRESS _______________________________________________________________________
DATE OF COMPLETION _________________________________________________________________

Please go to CCHGroup.com/PrintCPE to complete your Quizzer online for instant results and no Express Grading Fee. A $60.00 processing fee will be charged for each user submitting Module 3 for grading.

If you prefer to mail or fax your Quizzer, remove both pages of the Answer Sheet from this book and return them with your completed Evaluation Form to: CCH Continuing Education Department, 4025 W. Peterson Ave., Chicago, IL 60646-6085 or fax your Answer Sheet to CCH at 773-866-3084. You must also select a method of payment below.

METHOD OF PAYMENT:

☐ Check Enclosed  ☐ Visa  ☐ Master Card  ☐ AmEx
☐ Discover  ☐ CCH Account* ________________________________

Card No. ________________________________ Exp. Date ______________
Signature _________________________________________________________________________

EXPRESS GRADING: Please fax my Course results to me by 5:00 p.m. the business day following your receipt of this Answer Sheet. By checking this box I authorize CCH to charge $19.00 for this service.

☐ Express Grading $19.00  Fax No. ________________________________

* Must provide CCH account number for this payment option
Module 3: Answer Sheet

Please answer the questions by indicating the appropriate letter next to the corresponding number.

51. ____ 58. ____ 64. ____ 70. ____
52. ____ 59. ____ 65. ____ 71. ____
53. ____ 60. ____ 66. ____ 72. ____
54. ____ 61. ____ 67. ____ 73. ____
55. ____ 62. ____ 68. ____ 74. ____
56. ____ 63. ____ 69. ____ 75. ____
57. ____

Please complete the Evaluation Form (located after the Module 4 Answer Sheet) and return it with this Quizzer Answer Sheet to CCH at the address on the previous page. Thank you.
Module 4: Answer Sheet

NAME __________________________________________________________

COMPANY NAME __________________________________________________

STREET __________________________________________________________

CITY, STATE, & ZIP CODE __________________________________________

BUSINESS PHONE NUMBER _________________________________________

E-MAIL ADDRESS __________________________________________________

DATE OF COMPLETION _____________________________________________

Please go to CCHGroup.com/PrintCPE to complete your Quizzer online for instant results and no Express Grading Fee. A $48.00 processing fee will be charged for each user submitting Module 4 for grading.

If you prefer to mail or fax your Quizzer, remove both pages of the Answer Sheet from this book and return them with your completed Evaluation Form to: CCH Continuing Education Department, 4025 W. Peterson Ave., Chicago, IL 60646-6085 or fax your Answer Sheet to CCH at 773-866-3084. You must also select a method of payment below.

METHOD OF PAYMENT:

☐ Check Enclosed     ☐ Visa        ☐ Master Card       ☐ AmEx

☐ Discover          ☐ CCH Account* ________________________________

Card No. ________________________________ Exp. Date _____________

Signature _____________________________________________________

EXPRESS GRADING: Please fax my Course results to me by 5:00 p.m. the business day following your receipt of this Answer Sheet. By checking this box I authorize CCH to charge $19.00 for this service.

☐ Express Grading $19.00  Fax No. ________________________________

* Must provide CCH account number for this payment option
Module 4: Answer Sheet

Please answer the questions by indicating the appropriate letter next to the corresponding number.

76. ___  81. ___  86. ___  91. ___  
77. ___  82. ___  87. ___  92. ___  
78. ___  83. ___  88. ___  93. ___  
79. ___  84. ___  89. ___  94. ___  
80. ___  85. ___  90. ___  95. ___  

Please complete the Evaluation Form (located after the Module 4 Answer Sheet) and return it with this Quizzer Answer Sheet to CCH at the address on the previous page. Thank you.
TOP AUDITING ISSUES FOR 2013 CPE COURSE (4286-5)

Evaluation Form

Please take a few moments to fill out and mail or fax this evaluation to CCH so that we can better provide you with the type of self-study programs you want and need. Thank you.

About This Program

1. Please circle the number that best reflects the extent of your agreement with the following statements:

<table>
<thead>
<tr>
<th>a. The Course objectives were met.</th>
<th>Strongly Agree</th>
<th>Strongly Disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 4 3 2 1</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>b. This Course was comprehensive and organized.</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 4 3 2 1</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>c. The content was current and technically accurate.</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 4 3 2 1</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>d. This Course was timely and relevant.</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 4 3 2 1</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>e. The prerequisite requirements were appropriate.</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 4 3 2 1</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>f. This Course was a valuable learning experience.</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 4 3 2 1</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>g. The Course completion time was appropriate.</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 4 3 2 1</td>
</tr>
</tbody>
</table>

2. This Course was most valuable to me because of:

   - Continuing Education credit
   - Relevance to my practice/employment
   - Price
   - Convenience of format
   - Timeliness of subject matter
   - Reputation of author
   - Other (please specify) ____________________________

3. How long did it take to complete this Course? (Please include the total time spent reading or studying reference materials and completing CPE Quizzer).

   Module 1 ______  Module 2 ______  Module 3 ______  Module 4 ______

4. What do you consider to be the strong points of this Course?

5. What improvements can we make to this Course?
TOP AUDITING ISSUES FOR 2013 CPE COURSE

Evaluation Form cont’d

General Interests
1. Preferred method of self-study instruction:
   ____ Text  ____ Audio  ____ Computer-based/Multimedia  ____ Video

2. What specific topics would you like CCH to develop as self-study CPE programs? ___
   ___________________________________________________________________
   ___________________________________________________________________
   ___________________________________________________________________

3. Please list other topics of interest to you _____________________________________
   ___________________________________________________________________
   ___________________________________________________________________

About You
1. Your profession:
   ____ CPA  ____ Enrolled Agent
   ____ Attorney  ____ Tax Preparer
   ____ Financial Planner  ____ Other (please specify)

2. Your employment:
   ____ Self-employed  ____ Public Accounting Firm
   ____ Service Industry  ____ Non-Service Industry
   ____ Banking/Finance  ____ Government
   ____ Education  ____ Other

3. Size of firm/corporation:
   ____ 1  ____ 2-5  ____ 6-10  ____ 11-20  ____ 21-50  ____ 51+

4. Your Name __________________________
   Firm/Company Name __________________________
   Address __________________________
   City, State, Zip Code __________________________
   E-mail Address __________________________

THANK YOU FOR TAKING THE TIME TO COMPLETE THIS SURVEY!
CCH LEARNING CENTER

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