Comprehensive engagement manual, Volume 1: Engagement performance

George Marthinuss

Luis E. Cabrera

AICPA

Comprehensive Engagement Manual

INTEGRATED
PRACTICE
SYSTEM

VOLUME 1

AICPA

VOLUME 1: Engagement Performance

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Authors:
George Marthinuss, CPA
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PRACTICE

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This manual has not been approved, disapproved, or otherwise acted upon by any senior technical committees of the American Institute of Certified Public Accountants or the Financial Accounting Standards Board and has no official or authoritative status.

The manual is issued as a nonauthoritative kit of practice aids and is not intended as a substitute for professional judgment or for authoritative technical literature.

The documentation in this manual is not a substitute for development and implementation by a firm of a system of quality control that is appropriately comprehensive and suitably designed in relation to the firm's organizational structure, its policies, and the nature of its practice.

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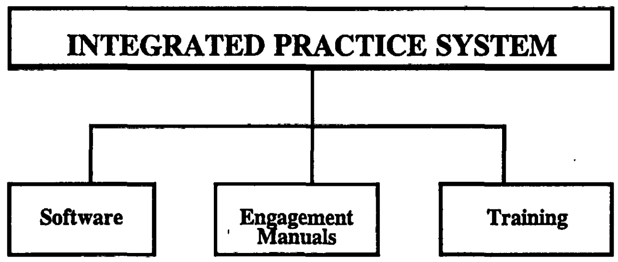
The AICPA Integrated Practice System:
For CPAs Concerned About Quality and Profitability



The Integrated Practice System gives practitioners the tools they need to conduct high-quality and cost-effective engagements. How? By enabling CPAs to anticipate engagement problems and by putting the solutions to these problems — integrated engagement manuals, software products, and training resources — within their grasp.

ONE SYSTEM, ONE SOLUTION

This innovative system is the *first* integrated system that is specifically designed to enhance the quality of your practice. It offers guidance on the day-to-day management of client engagements and provides practical discussions on the applicability of authoritative literature. Each element of the system — manuals, software, and training — was developed by CPAs who recognized the need to provide a comprehensive, hands-on approach to engagement planning and performance. Working alone or as a unified system, Integrated Practice System products provide the solutions needed for a firm to achieve top-quality performance and bottom-line profitability.

INTEGRATED PRACTICE SYSTEM — IN A CLASS BY ITSELF

Significant advantages distinguish these tools from other commercially available products. The Integrated Practice System tools —

- **Represent an integrated, synergistic system** that is state-of-the-art.

- **Include access to technical support hotlines** that put you in touch with professionals who can answer your technical questions. Just call the following numbers:

  Engagement Manuals 800-TO-AICPA (800-862-4272)

  Software Products 800-226-5800

  Training 201-938-3060

- **Receive ongoing field-testing and evaluation** from a task force of the AICPA's Private Companies Practice Section (PCPS) — CPAs who confront similar challenges in their practices and who represent the interests of local and regional firms.

- **Include a 60-day "no-questions-asked" return guarantee** that allows you the time to try the Integrated Practice System products and find out for yourself how your firm and staff can benefit from them.

ENGAGEMENT MANUALS: THE SMART KID ON THE BLOCK

Finally, there is a reliable, step-by-step approach for managing and performing your engagements. The Engagement Manuals point you in the right direction with the time-saving tools you need to conduct high-quality engagements with the greatest efficiency. Right from the start, the Engagement Manuals show you a direct route to protecting your bottom line. You can minimize on-site field work and put an end to "over-auditing" because our exclusive "ABC System" helps you evaluate risk in the critical planning stage. You'll find important guidelines to use in evaluating your client, so that you can adjust the level of testing to the internal controls employed by the client.

The Engagement Manuals feature a practical, "how-to" approach that enables you and your staff to cut through the clutter and focus on what's important. By eliminating time-consuming guesswork, they chart the course to the most cost-effective, efficient way of proceeding with your engagement. Plus, the manuals include ready-to-use forms, programs, checklists, and questionnaires — even sample correspondence to speed your work.

Each Engagement Manual includes —

- Guidance based on the most recent relevant authoritative and non-authoritative literature;
- Integrated work programs and checklists;
- Model letters ready for your use;
- Time-saving worksheets that capture important information and also help users identify opportunities for other services that can be provided to existing clients, such as consulting and tax services and the preparation of prospective financial information.
- Diskettes, in WordPerfect format, that include all the sample letters and accountant's/auditor's reports included in the manual.

What's more, the Engagement Manuals ease the process of quality review by helping you develop the documentation you need.

The Engagement Manuals can be easily used as stand-alone practice aids. Or, you can use them in conjunction with the full complement of software products — including the AICPA's very successful Accountant's Trial Balance (ATB) and Audit Program Generator (APG). It's the flexibility you need for a cost-efficient, high-quality engagement.

The AICPA recognizes your need to be up-to-date on issues that affect your clients — that's why subscribers automatically receive annual updates for the engagement manuals. Our goal, pure and simple: to provide the answers to your questions even before you ask them.

Because the AICPA has an ongoing commitment to developing the practice aids you need to serve your clients, it will continue to release new industry-specific manuals. These will contain the same kind of practical tools and how-to guidance that are the hallmarks of the Engagement Manuals.

Comprehensive Engagement Manual

The *Comprehensive Engagement Manual* can help practitioners manage most engagements. Designed to be the accountant's companion to audit, review, and compilation engagements, this manual includes checklists, forms, flowcharts, questionnaires, tables, and all the documentation necessary for any size client.

This four-volume set covers engagement performance, documentation and reporting, and helps you make key decisions, including —

- Assessing risk and establishing materiality limits;
- Selecting the most cost-beneficial audit approach;
- Designing the most economical auditing procedures; and
- Making sampling decisions that maximize efficiency.

The *Comprehensive Engagement Manual* features the unique and highly-popular "ABC System" that enables practitioners to identify the most cost-beneficial mix of tests of controls, substantive tests of balances, and analytical procedures for specific engagements. This manual is ideal for firms that want a system they can apply to the full spectrum of audit engagements — whether they plan to perform tests of controls or a totally substantive audit.

Small Business Audit Manual

The two-volume *Small Business Audit Manual*, an alternative to the *Comprehensive Engagement Manual*, walks you through each step of the audit of a small business client. Designed for firms that use a substantive testing approach on all of their audits, the *Small Business Audit Manual* helps you to:

- Plan a cost-effective and time-efficient engagement;
- Verify all financial statement assertions using substantive tests;
- Understand a client's internal control structure;
- Better understand how to apply authoritative standards to small business audits;
- Evaluate a small business' computer needs.

The *Small Business Audit Manual* also puts at your fingertips sample audit programs, questionnaires, model letters, time sheets, workpapers, and audit reports for a small business audit engagement — organized in the sequence they will be used. If your firm's audits rely totally on substantive testing, this is the manual for you.

Bank and Savings Institutions Audit Manual

The three-volume *Bank and Savings Institutions Audit Manual* can help you cope with the high risk generally associated with bank audits and the complexity of bank operations. It is designed to enable you to perform high-quality engagements with maximum time savings. Based on the unique "ABC System," this manual allows you to design the most efficient and cost-effective mix of tests of controls and substantive tests of balances, and analytical procedures. It does so by including:

- A framework to help practitioners design the most cost-effective audit strategy;
- Worksheets and forms to help auditors understand a bank's internal control structure and assess risk during engagement planning.
- Programs for interim work;
- Sampling documentation and discussions of professional standards that affect the sampling decision;
- Worksheets for various analytical procedures that can help to identify errors and irregularities.

Construction Contractors Audit Manual

You'll find this two-volume manual your most valuable practice aid when working on engagements for construction contractors. It contains:

- Two audit approaches—the "System's Walk-through Approach" for substantive audits and the "ABC System" — to help you design the most efficient and effective audit strategy for each engagement;
- Practical, how-to guidance for completing construction contractor audits;
- A chapter dedicated to the surety industry to help you understand what the surety wants and needs;
- All the necessary audit programs, forms, checklists, sample correspondence, and working papers to comply with today's quality control standards;
- A supplemental tax preparation checklist specific for construction contractors;
- The AICPA Audit and Accounting Guide, *Construction Contractors*, which contains discussions on the applicability of specific professional standards to engagements for construction contractors.

Compilation and Review Manual

This two-volume set gives you a step-by-step system to help you conduct high quality compilation and review engagements — profitably and in compliance with all current applicable professional standards. It contains:

- Programs, checklists, and sample correspondence for performing compilation and review engagements;
- Reporting guidance for OCBOA and personal financial statements;
- Guidance on performing and reporting on prospective financial information.

Credit Union Audit Manual

The two-volume set outlines the most efficient way to approach audits of credit unions and contains guidance on conducting them in compliance with current professional standards. This manual uses the "ABC System" and a newly designed audit strategy for small credit unions, which allows you to choose the best mix of tests of controls and substantive tests of balances, and analytical procedures for each engagement. This manual contains:

- Audit programs, forms, checklists, working papers, and illustrations necessary to perform credit union audits and supervisory examinations;
- The AICPA Audit and Accounting Guide, *Audits of Credit Unions*;
- The most recent checklists and illustrative financial statements for credit unions.

Quality Control Manual for CPA Firms

The *Quality Control Manual for CPA Firms*, gives you a step-by-step practical approach to establishing and maintaining your quality control system. Written by CPAs who have extensive peer review experience, it provides all of the guidance and forms you will need, without overburdening you with unnecessary and complex documentation. This manual can be used by firms of all sizes, but its simple approach was designed with the small-to-medium-size firm in mind.

Not-for-Profit Organizations Audit Manual

The two-volume *Not-for-Profit Organizations Audit Manual* contains everything you need to conduct high-quality audits—audit programs, forms, checklists, and sample auditor's reports and financial statements developed especially for not-for-profit organization audits. Also discussed in this manual are two recently-released FASB Statements of Financial Accounting Standards on contributions and not-for-profit organizations' financial statements, as well as FASB's exposure draft on investments, the proposed AICPA Statement of Position on joint activities, and the AICPA's proposed Audit and Accounting Guide for not-for-profit organizations. The manual also helps you efficiently test the compliance requirements of the Yellow Book and OMB Circular A-133.

Auto Dealership Engagement Manual

The *Auto Dealership Engagement Manual* guides you through the twists and turns of an auto dealership audit. Developed to help you conduct effective and efficient engagements in this turbulent industry, it provides guidance that until now has been lacking. This manual includes:

- Two audit approaches — the All Substantive Approach for primarily substantive audits and the unique "ABC System" for audits in which it is efficient to test controls;
- An overview of the industry, including operating characteristics;
- Tailored audit programs and internal controls questionnaire;
- Discussion of auto dealership's unique accounting principles and practices;
- Sample auditor's reports and financial statements; and
- Tax information, including complex LIFO calculations and extended warranty service revenue recognition rules.

SOFTWARE — THE ELECTRONIC EDGE

The AICPA's software products — ATB Write-Up, Accountant's Trial Balance (ATB) and its modules, Audit Program Generator (APG), Engagement Manager (EM) and Depreciation, among others — put the solutions to daily practice problems at your fingertips. Together with the Engagement Manuals, they streamline engagement planning and performance, and enable you to more effectively monitor your staff and your budget. Most importantly, they prevent you from reinventing the wheel each time you plan and conduct an engagement.

It's easy to put these products to work for you. The software requires an IBM PC, XT, AT, PS/2 or IBM-compatible system and DOS version 3.1 or higher. A team of professionals is available to answer any of your questions; simply call the Software Support Hotline at 800-226-5800 or use the Software Express FAX service at 800-226-6868.

ATB Write-Up

ATB Write-Up features powerful options that let you analyze information and generate reports and financial statements quickly and easily. ATB Write-Up takes all of the power and flexibility of ATB, ATB Financial Statements, and ATB Consolidations and adds to it. ATB Write-Up offers:

- Period Reporting — Use up to 13 periods per year. This gives you the flexibility to generate annual, semiannual, quarterly or monthly reports.

- Departmental Reporting — Set up as many departments as you need. ATB Write-Up will print most workpapers and reports by department, in total for all departments, or for a selected range of departments.
- Financial Statements — Up to 16 columns, each custom-definable to include periods, departments, year-to-date, percentages, add columns together, and more.
- Consolidations — Link and combine accounts of related groups into one consolidated company.

Accountant's Trial Balance

ATB, the best-selling, most-used accounting software in the profession today, is an integral part of the IPS family. Designed ***by*** accountants ***for*** accountants and used by approximately 9,000 accounting firms, ATB automates much of the routine work associated with trial balance and financial statement preparation. Specifically, it:

- Generates picture-perfect working papers, including trial balances, journals, lead schedules, user-definable grouping schedules, and analytical review worksheets;
- Enables users to prepare trial balances based on GAAP, federal tax, state tax, or other user-selected accounting bases;
- Keeps up to five years of data on file for any one client, enabling you to generate a variety of comparative reports quickly and simply.

Modules for Use with ATB 3.0

- *ATB Financial Statements* — This powerful report writer enables you to produce final financial statements quickly and easily.
- *ATB Consolidations* — This module enables you to consolidate trial balances from up to nine individual companies into one ATB company trial balance — with ATB automatically keeping track of all activities.
- *ATB Conversion* — With ATB Conversion you can transfer any data electronically from a number of general ledger and working paper packages to ATB and from ATB to leading corporate tax preparation packages.

Audit Program Generator

The Audit Program Generator (APG) enables you to customize an audit program or a checklist to a particular client. Its unique features help you save time and unnecessary expense in conducting audits. Since its introduction in 1987, over 8,000 firms have used APG.

APG Version 2.0 enables you to —

- Create a variety of programs and checklists, including audit programs, disclosure checklists, and compliance checklists;
- Tailor the audit program to the needs of your specific client;
- Customize programs from a wide variety of sample AICPA work programs available in electronic format;
- Quickly link your audit procedures and financial statement assertions;
- Use a full-text editor to customize titles and footers and create appropriate tabular formats.

Engagement Manager

The Engagement Manager (EM) software package can assist you in planning, analyzing, documenting, and correcting engagement management problems — and free up valuable staff time in the process. Most importantly, it handles the details of creating and modifying budgets, recording actual time and expenses, and comparing results so you can devote your energy to other aspects of your business. With EM's help, you can:

- Anticipate potential budget variances and delays through a variety of analytical reports;
- Spot potential problems while there is time to take action;
- Determine the effectiveness of individual staff members by analyzing their efficiency in assigned areas.

Depreciation

Depreciation provides a simple and efficient means of calculating and tracking how assets are depreciated. It calculates depreciation for six separate reporting bases: book, federal, state, AMT, ACE, and "other." What's more, it lets you apply various methods of depreciation to any of these reports and prints out complete worksheets showing changes in various property accounts and the necessary journal entries to record depreciation for the year. Now, with its pull-down menus, Depreciation is easier to use than ever.

Reports generated through AICPA Depreciation include:

- Depreciation schedules by category, G/L account number, system, or convention
- Summarized worksheet information for Forms 4255, 4562, 4626, 4797, 6252, and Schedule D
- AMT preference calculation
- ACE adjustment calculation
- Fully depreciated assets report
- Amortization report
- Section 179 deduction report
- ITC-taken report
- Basis comparison
- Depreciation account reconciliation
- Amortization account reconciliation
- Schedule M-1 information
- Overridden calculations

TRAINING RESOURCES: MAKING THE INTEGRATED PRACTICE SYSTEM WORK FOR YOU

Whether you're a user of one or more of the Integrated Practice System products or you're looking for ways to more effectively manage engagements, Training Resources can benefit you. You'll learn how the Engagement Manuals and Software can help your practice run more smoothly and how the system works to facilitate productivity, efficiency, and quality performance by you and your staff.

The Training Resources come in three formats: self-study or self-administered group study; customized in-house group study; and conferences. Here is what's available in each format:

Self-Study or Self-Administered Group Study

An ***Orientation and Technical Update Seminar*** is a formal group study-program designed to assist firms with initially implementing the Integrated Practice System Engagement Manuals. It also provides a monitored self-study orientation on the manuals for new staff. The seminar materials can help you to better understand and apply common SASs in the most efficient manner. You'll learn how to design tests, auditing procedures and sample sizes to collect the right amount of evidence needed for particular engagements.

Accountant's Trial Balance — CPE Edition is a self-study course that teaches you how to automate your working papers for all types of engagements. You'll earn eight hours of CPE credit as you become familiar with ATB and its most used features for audits, reviews, compilations, and tax working papers.

Accountants Trial Balance With Financial Statement Generator — CPE Edition is a self-study course that enables you to rapidly learn the basics of ATB and the Financial Statement Generator add-on module. The recommended CPE credit for this course is eight hours.

Customized In-House Group Study

Special in-firm training is available to demonstrate how your firm can put the Integrated Practice System products to use. And you'll see immediate results. That's because the training leader will use a current client engagement ***you select*** as the training model. Whether you select a one- or two-day training program, you'll learn how IPS products can help you address real client needs and resolve specific client problems.

AICPA Conferences

Training sessions focusing on the Engagement Manuals are part of many AICPA conferences designed for local and regional practitioners, including the highly rated PCPS Conference and the National Accounting and Auditing Advanced Technical Symposium.

To schedule in-firm training or to obtain more information about the Integrated Practice System Training Resources, including dates and locations of these conferences, call the AICPA Technical Information Division at (201) 938-3060.

AICPA INTEGRATED PRACTICE SYSTEM
COMPREHENSIVE ENGAGEMENT MANUAL

PREFACE

The AICPA *Comprehensive Engagement Manual* is a comprehensive tool kit for performing audit, review, and compilation engagements. The overall approach presented in this Manual is designed to maximize quality and efficiency for your engagements. This all-purpose Manual includes all the essentials — checklists, forms, flowcharts, questionnaires, and tables. Our systematic approach provides guidance on engagement performance, documentation, and reporting.

This Manual is designed to comply with all applicable accounting and auditing pronouncements. References are made throughout to the authoritative pronouncements and cited to section numbers in AICPA *Professional Standards* and the FASB *Accounting Standards — Current Text*. Practitioners are encouraged to refer directly to the applicable technical literature.

The Manual's thorough documentation is an integral part of a firm's overall engagement quality control system. All the documentation is explained and illustrated in the Manual.

This four-volume Manual contains all of the documentation necessary to complete audit, review, and compilation engagements, arranged in the order it normally will be needed in the engagement:

- Client Acceptance and Continuance Form
- Engagement Letter
- Planning Matrix
- Planning Memorandum
- Compilation Engagement Work Program
- Review Engagement Work Program
- Tests of Controls Program
- Tests of Balances Audit Program
- Summary of Possible Journal Entries Form
- Materiality Computation Form
- Illustrative Work Papers and Correspondence
- Illustrative Reports

In addition, the Manual contains quality control and management supervision documents:

- Consultation forms
- Representation letters
- Engagement performance and review checklists
- Budgeting and time control documents

The *Comprehensive Engagement Manual* maximizes opportunities for additional services. Its checklists and other documentation are sources of meaningful suggestions that can be presented to clients and that ultimately may result in the performance of additional services.

Achieving both engagement quality and profitability requires extensive planning. The *Comprehensive Engagement Manual's* forms, checklists, and decision matrixes are documents that require planning to begin before any field work is done and to continue until engagement completion. The documents included in the Manual allow for timely executive review and involvement in the audit, review, or compilation program design and execution. Preparing and reviewing documentation helps develop skills of the in-charge and other staff and helps to identify problems early.

The *Comprehensive Engagement Manual* is designed to permit maximum flexibility in the approach to engagements. All the programs are designed to fit the client circumstances encountered.

ABOUT THE AUTHORS

GEORGE L. MARTHINUSS, JR., CPA, CFP

George Marthinuss, CPA, CFP, is president of CPE Institute, Inc. and a former partner in the regional firm of Keller, Zanger, Bissell & Company in Rockville, MD. He has over 25 years of experience in public accounting for national, regional, and local firms.

Mr. Marthinuss holds an MBA from the University of Maryland, where he was also an instructor and the faculty advisor to Beta Alpha Psi. Mr. Marthinuss is past chairman of the AICPA Accounting and Review Services Committee and formerly served on the AICPA CPE Curriculum & Quality Control Subcommittee. He is an active member of the Institute of Certified Financial Planners, the International Association of Financial Planning, the Construction Financial Management Association, and the Suburban Maryland Building Industry Association.

LUIS E. CABRERA, CPA

Luis E. Cabrera, CPA, is a Technical Manager with the AICPA's Technical Information Division and holds a BBA from Baruch College, where he is also an adjunct professor of accountancy.

Mr. Cabrera was previously a senior accountant in the national office of Pannell Kerr Forster, P.C. and an internal auditor with the Chase Manhattan Bank, N.A. He was also a senior auditor with Coopers & Lybrand.

PEER REVIEW OF THE AICPA INTEGRATED PRACTICE SYSTEM

COMPREHENSIVE ENGAGEMENT MANUAL

In keeping with our commitment to give you reliable practice aids, we engaged the CPA firm, Baird, Kurtz & Dobson, to perform a peer review of the *Comprehensive Engagement Manual*. Using quality control materials that have been peer reviewed serves two purposes: (1) it provides reasonable assurance that the materials are reliable practice aids; and (2) it helps to minimize the cost of your firm's peer review.

A copy of Baird, Kurtz & Dobson's unqualified peer review report is included on the following page. This report has been accepted by the Private Companies Practice Section and the SEC Practice Section of the AICPA's Division for CPA Firms. Although the report addresses the 1994 edition of this Manual, it is valid for three years.

Baird,
Kurtz &
Dobson

Certified
Public
Accountants

With Offices in:
Arkansas
Colorado
Kansas
Kentucky
Missouri
Nebraska
Oklahoma

Member of
Moores Rowland
International

January 24, 1995

The Board of Directors
American Institute of Certified
Public Accountants

We have reviewed the system of quality control for the development and maintenance of the 1994 edition of the *Comprehensive Engagement Manual* (materials) of the **AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA)** in effect for the year ended December 31, 1994 and the resultant materials in effect at December 31, 1994, in order to determine whether the materials are reliable aids to assist users in conforming with those professional standards the materials purport to encompass. Our review was conducted in accordance with the standards for reviews of quality control materials promulgated by the peer review committees of the Private Companies Practice Section and the SEC Practice Section of the AICPA Division for CPA Firms.

In performing our review, we have given consideration to the following general characteristics of a system of quality control. An organization's system for the development and maintenance of quality control materials encompasses its organizational structure and the policies and procedures established to provide the users of its materials with reasonable assurance that the quality control materials are reliable aids to assist them in conforming with professional standards in conducting their accounting and auditing practices. The extent of an organization's quality control policies and procedures for the development and maintenance of quality control materials and the manner in which they are implemented will depend upon a variety of factors, such as the size and organizational structure of the organization and the nature of the materials provided to users. Variance in individual performance and professional interpretation affects the degree of compliance with prescribed quality control policies and procedures. Therefore, adherence to all policies and procedures in every case may not be possible.

Our review and tests were limited to the system of quality control for the development and maintenance of the aforementioned materials of the AICPA and to the materials themselves and did not extend to the application of these materials by users of the materials nor to the policies and procedures of individual users.

In our opinion, the system of quality control for the development and maintenance of the quality control materials of the AICPA was suitably designed and was being complied with during the year ended December 31, 1994 to provide users of the materials with reasonable assurance that the materials are reliable aids to assist them in conforming with those professional standards the materials purport to encompass. Also, in our opinion, the quality control materials referred to above are reliable aids at December 31, 1994.

Baird, Kurtz & Dobson

SUGGESTED REVISIONS TO COMPREHENSIVE ENGAGEMENT MANUAL

Please submit all suggestions to improve the quality of the Comprehensive Engagement Manual as they arise. We value users' input and will give all comments consideration when revising the manual.

To:
Susan Menelaides, CPA, Director
Technical Information Division
AICPA
Harborside Financial Center
201 Plaza Three
Jersey City, NJ 07311-3881

From:

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(Name)

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(Firm)

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(Address)

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(Telephone No.)

Suggested Revisions:

Page No.	Comments

(Please attach additional sheets if necessary)

AUDIT MANUAL ADVISORY TASK FORCE

The manuals in the AICPA Integrated Practice System (IPS) are monitored by a special PCPS Audit Manual Advisory Task Force. Task force members use the manuals in their audit and accounting practices and continuously provide the AICPA staff with recommendations to enhance the manuals from the perspective of the small- and medium-sized firm.

MEMBERS OF THE AICPA PRIVATE COMPANIES PRACTICE SECTION (PCPS) AUDIT MANUAL ADVISORY TASK FORCE

Edward F. Rockman, *Chairman*
Ernest F. Baugh, Jr.
John R. Benham, Jr.
Michael R. Council
Robin Hoag
William Metz
Ron Rauch

AICPA INTEGRATED PRACTICE SYSTEM
COMPREHENSIVE ENGAGEMENT MANUAL

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VOLUME FOUR — REPORTING

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CHAPTER 1

INTRODUCTION

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CHAPTER 1

INTRODUCTION

1.000 OBJECTIVES OF THE MANUAL

1.001 This Manual provides thorough, practical, up-to-date guidance for accountants engaged to perform audit, review, and compilation services on financial statements of nonpublic entities. This Manual is designed as a nonauthoritative aid intended to make this guidance easy to find and easy to apply.

1.002 The Manual's primary purpose is to provide the guidance, work programs, checklists, sample correspondence and reports, and forms necessary to perform quality engagements in the most cost-beneficial manner and in compliance with applicable authoritative pronouncements. This Manual provides two different audit approaches—the ABC System and the All-Substantive Approach. These approaches, which are discussed in detail in Chapter 3, are comprised of all of the engagement planning and performance documentation needed, whether you are using an all-substantive audit approach (the All-Substantive Approach) or you plan to assess control risk at below the maximum and perform tests of controls for one or more financial statement assertions (the ABC System).

1.100 ORGANIZATION AND CONTENT OF THE MANUAL

1.101 The Manual consists of 22 chapters contained in four looseleaf binders. Chapters 1 through 8 are presented in Volume 1, Chapters 9 through 10 are in Volume 2, Chapters 11 through 14 are in Volume 3, and Chapters 15 through 22 are in Volume 4. Each volume contains a complete index. The first volume discusses the engagement performance process and sets the foundation for implementing the ABC System and the All-Substantive Approach to audits (discussed in Chapter 3). The second and third volumes have all the necessary documentation forms, checklists, and sample correspondence. The fourth volume provides sample auditor and accountant reports, a reporting checklist, and a continuing professional education (CPE) course. In addition, "Practice Tips" and "Audit Alerts" (boxed areas) included throughout the Manual provide helpful hints about applying the matters discussed in the Manual in practice.

1.102 Each section in the Manual is assigned a four-digit number; for example, this section is 1.102. The first digit is the chapter number, the second digit identifies the topic (subheading) discussed in the section, and the last two digits identify the section number. Thus, in the reference 1.102, the first digit, (1), refers to Chapter 1, the second digit, (1), refers to the chapter section, and the last two digits, (02), refer to the section number.

1.103 Page numbers appear on the top of each page. The number(s) before the hyphen represent the chapter number and the number(s) after the hyphen represent the page number.

1.200 HOW TO USE THIS MANUAL

1.201 The Manual is divided into three basic parts. The first part, dealing with engagement performance, is in Volume 1. It discusses five types of engagements: large audits, small audits, reviews, compilations with full disclosures, and compilations with substantially all disclosures omitted. Volumes 2 and 3 contain the documentation forms, checklists, sample correspondence, and sample workpapers. Volume 4, the Reporting Volume, contains sample reports and checklists for each type of engagement. A 4-credit hour CPE course is also contained in Volume 4.

1.202 The remaining paragraphs in this section provide an overview of the contents of each chapter.

1.203 Chapter 2 discusses pre-engagement considerations and audit planning. It provides an overview of the financial statement assertions to be verified in an audit, the types of controls to be tested, the different types of audit approaches and when they may be appropriate, the four basic audit planning decisions, and how to evaluate overall engagement risk.

1.204 Chapter 3 discusses the ABC System and the All-Substantive Approach to planning and performing an audit. This chapter also discusses sampling, the Audit Planning Memorandum, the Planning Matrix, the Evidence Matrix, and the Risk of Potential Misstatements Matrix.

1.205 Chapter 4 pertains to compilation and review engagements. It discusses the performance requirements for those engagements, including special engagements such as presentations on other comprehensive bases of accounting and on prescribed forms.

1.206 Chapter 5 discusses the requirements for accumulating evidence in an audit engagement. It contains a discussion of the confirmation requirements and matters concerning first-year engagements and computer auditing considerations.

1.207 Chapter 6 presents the basic documentation requirements for audit, review, and compilation engagements and includes guidance for working paper preparation.

1.208 Chapter 7 provides a step-by-step approach to organizing and controlling engagement completion. It lists and explains all the necessary wrap-up documentation, including the sign-offs, appraisal forms, and the internal control structure communication requirements.

1.209 Chapter 8 provides guidance on supervising the engagement and how to effectively utilize the performance results to provide on-the-job staff training and prepare for next year's engagement.

1.210 In Volume 2, Chapter 10 provides the documentation forms, memoranda, checklists, and audit programs necessary to perform an audit engagement under the ABC System and the All-Substantive Approach. The sample audit programs, forms, and checklists included in this Manual should be tailored to each engagement's circumstances, and also to the firm's quality control policies and procedures. (Chapter 9 is the introductory chapter.)

1.211 Chapters 11 and 12 in Volume 3 contain additional forms, such as time control documents, and the supervision and review checklists.

1.212 Chapter 13 provides sample correspondence and confirmation letters and forms, including instructions on how to use them.

1.213 Chapter 14 contains a set of illustrative working papers designed to help organize, plan, perform, and complete an audit or an accounting service engagement.

1.214 Volume 4 is the Reporting Volume, and is designed to assist in reporting on audit, review, and compilation engagements.

1.215 Chapter 16 discusses the approach to drafting financial statements, and to writing notes and reports. It also contains an illustrative cash flows working paper. (Chapter 15 is the introductory chapter.)

1.216 Chapter 17 provides guidance on financial statement format, disclosures, and terminology. It discusses, among other matters, consolidated and combined financial statements, accounting for business combinations, subsequent events, and accounting changes.

1.217 Chapter 18 contains a comprehensive financial statement disclosure and reporting checklist, with illustrative financial statements and notes.

1.218 Chapter 19 provides guidance on reporting on audited financial statements. It includes an Audit Reporting Summary, which summarizes common situations that may result in a modification of the standard auditor's report, and refers the user to the sections in the Manual that contain sample report language describing those modifications.

1.219 Chapter 20 provides guidance on reporting on compilation and review engagements. It covers modification of the standard accountant's report and gives sample report language. It also discusses how to report if a different level of service was performed in the prior period.

1.220 Chapter 21, **added this year,** is a consulting services chapter designed to help practitioners develop a business plan for a client.

1.221 Chapter 22 contains a 4-credit hour CPE course focusing on the practical application of key Statements on Auditing Standards (SASs).

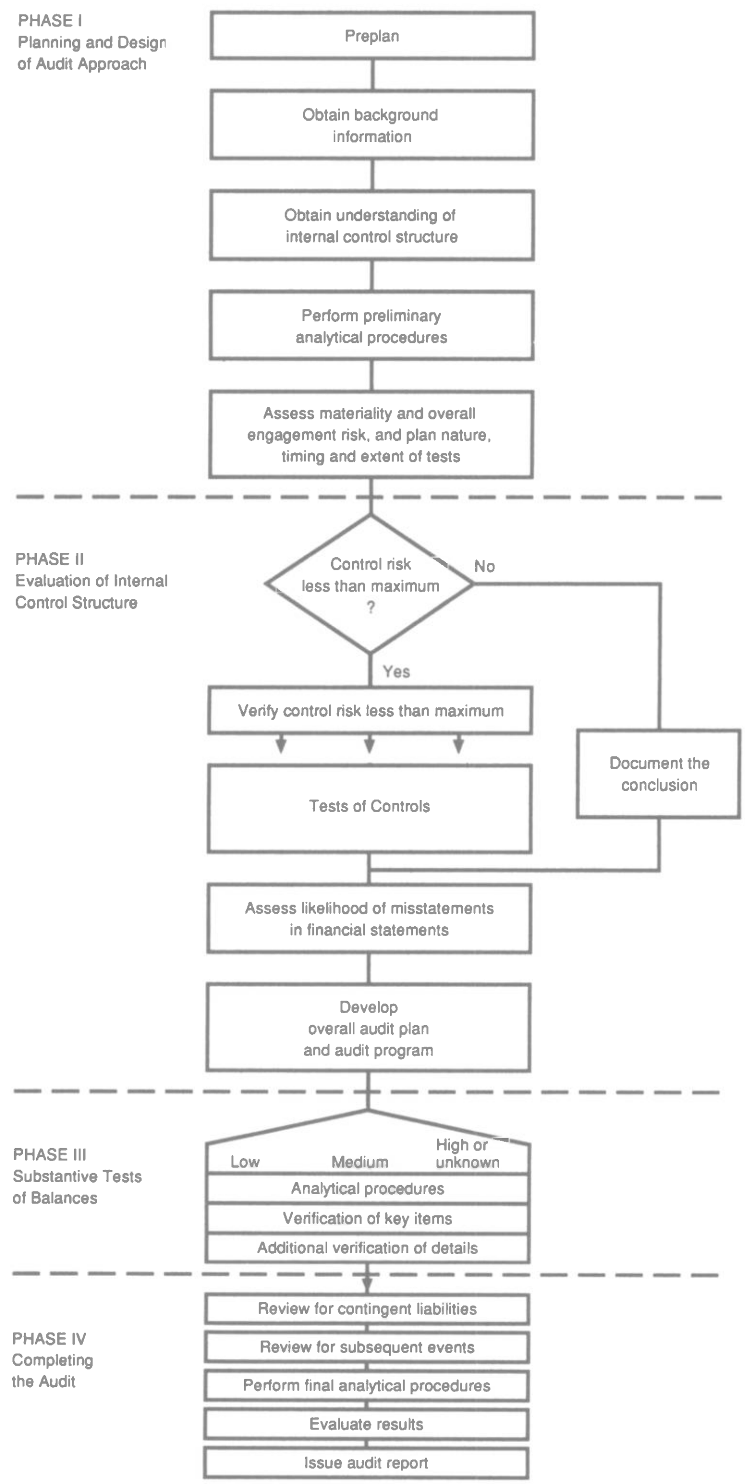
1.222 The authors hope that you will find this Manual easy to use. We would appreciate your comments and suggestions.

1.300 AUDIT, COMPILATION, AND REVIEW PHILOSOPHIES

1.301 Since the birth of our profession, the audit function has been considered the expression of an opinion on audited financial statements. Such expression of opinion is, of course, based on obtaining an understanding of the internal control structure, tests of controls, substantive tests, and compliance with other professional standards. The professional standards for audit engagements are set forth in the Statements on Auditing Standards (SASs), and related Interpretations. In addition, attestation engagements are covered by the Statements on Standards for Attestation Engagements (SSAEs). Accountants also perform compilations and reviews of financial statements. This requires following the Statements on Standards for Accounting and Review Services (SSARSs). Application of those standards requires extensive use of common sense and professional judgment. Forms, checklists, and other documentation included in this Manual are designed to comply with the substance of applicable pronouncements. An overview of the approach to auditing engagements is presented in Illustration No. 1-1. An overview of the approach for compilations and reviews is included in Illustration Nos. 1-2 and 1-3, respectively.

SUMMARY OF THE AUDIT PROCESS

ILLUSTRATION NO. 1-1



1.400 MEETING PROFESSIONAL STANDARDS

1.401 Although applicable professional standards may vary with the nature of an engagement, the approaches in this Manual are designed to comply with the following standards:

- AICPA *Code of Professional Conduct*
- Generally accepted accounting principles (GAAP)
- Generally accepted auditing standards (GAAS)
- Standards for Accounting and Review Services (SSARS)
- Standards for Attestation Engagements (SSAE)
- Firm policies and procedures
- Quality control standards

1.402 All staff persons have the responsibility to research and know the professional standards applicable to their assigned work areas.

Code of Professional Conduct

1.403 The AICPA's *Code of Professional Conduct* (Code) and similar codes of the state societies of CPAs are the governing authorities. The codes are applicable to all areas of our practice and to all employees, staff, and partners of the firm. Firms should practice strict adherence to the letter and the spirit of these codes.

1.404 The AICPA's Code contains principles that express the profession's recognition of its responsibilities to the public, to clients, and to colleagues. The Code also contains specific rules for practice that must be adhered to by members of the AICPA. Certain rules having a direct impact on the performance of engagements are summarized below:

- Rule 101 — Independence

  Relating to auditing, review, compilation, and attestation engagements, Rule 101 requires independence in fact, and in appearance. Not only must accountants maintain an unbiased attitude throughout engagements, it must appear to third parties they are doing so. Three general circumstances may impair a CPA's independence.

  - Making managerial decisions for the client
  - Direct or indirect financial interest in the client including loans to and from the client
  - Familial relationships with a client's employees

1.405 Interpretations of the Rules of Conduct expand and clarify these concepts.

- Rule 102—Integrity and Objectivity

  In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.

- Rule 201—General Standards

  A member shall comply with the following standards and any related interpretations:

  a. *Professional Competence*. Undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence.

  b. *Due Professional Care*. Exercise due professional care in the performance of professional services.

  c. *Planning and Supervision*. Adequately plan and supervise the performance of professional services.

  d. *Sufficient Relevant Data*. Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

1.406 Engagement documentation should demonstrate compliance with these General Standards.

- Rule 301—Confidential Client Information

  Any information obtained in the course of an engagement or other association with a client may not be disclosed without the consent of the client. This Rule extends to the names of the firm's clients and nature of work performed for them. A good rule of thumb is not saying *anything* about the firm's clients to *anyone* outside the firm.

- Rule 501 — Acts Discreditable

  Applicable to all areas of CPAs' personal and professional lives, Rule 501 states, simply, that no member shall commit a discreditable act. Discreditable acts include such things as convicted criminal offenses, failure to return a client's records, employment discrimination, and failure to follow governmental or regulatory requirements.

1.500 THE GAAP HIERARCHY AND EITF CONSENSUSES

1.501 In January 1992, the AICPA's Auditing Standards Board issued SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles in the Independent Auditor's Report* (AU 411). Statement on Standards for Accounting and Review Services (SSARS) No. 7, *Omnibus Statement on Standards for Accounting and Review Services—1992* (AR 100, footnote 3), clarifies that the hierarchy also applies to compilation and review engagements. SAS No. 69:

- Created two separate but parallel hierarchies — one for state and local governments and another for nongovernmental entities.
- Established a true GAAP hierarchy — unlike the old SAS, each successive category in the hierarchy is a different level of authority.
- Elevated the authority of Financial Accounting Standards Board (FASB) Emerging Issues Task Force (EITF) consensuses and AICPA Practice Bulletins from "other literature" to "established accounting principles."

1.502 Paragraph 16 of SAS No. 69 (AU 411.16) summarizes the pronouncements that are included in each of the five categories of GAAP for nongovernmental entities and for state and local governments.

1.503 SAS No. 69 is effective for reports on financial statements for periods ending after March 15, 1992. Generally, the revised levels of authority apply to pronouncements with effective dates after March 15, 1992. However, EITF consensuses issued before March 16, 1992 also are effective for initial application of an accounting principle after March 15, 1993.

Importance of EITF Consensuses

1.504 The one-year grace period assigned to the old EITF consensuses was designed to give accountants an opportunity to become acquainted with over 150 consensuses that were adopted before March 16, 1992. The consensuses listed in sections 1.505 ("Selected EITF Consensuses Adopted Before March 16, 1992") and 1.506 ("Selected EITF Consensuses Adopted Between March 16, 1992 and July 21, 1995") have the widest applicability and relevance to commercial entities.

1.505 Selected EITF Consensuses Adopted Before March 16, 1992

Issue
Number Title and Issue

Balance-Sheet Classification

85-1 *Classifying Notes Received for Capital Stock*
Should notes received in exchange for capital stock be classified as an asset or as a reduction of equity?

86-30 *Classification of Obligations When a Violation is Waived by the Creditor*
How is the classification of long-term debt affected when the creditor waived existing debt covenant violations but retained future, periodic covenant requirements?

Contingencies

86-12 *Accounting by Insureds for Claims-Made Insurance Policies*
Should an enterprise record an incurred-but-not-reported (IBNR) liability for uninsured losses resulting from claims-made insurance policies?

Environmental Treatment Costs

89-13 *Accounting for the Cost of Asbestos Removal*
When may the costs of asbestos removal be capitalized, and, if expensed, may the costs be classified as an extraordinary item?

90-8 *Capitalization of Costs to Treat Environmental Contamination*
Should environmental contamination treatment costs be expensed or capitalized? Supplement to Issue No. 89-13.

Extinguishment of Debt

86-18 *Debtor's Accounting for a Modification of Debt Terms*
Should the exchange of a new noncallable debt instrument for an older callable debt instrument be accounted for as an extinguishment of the older debt issue?

89-15 *Accounting for a Modification of Debt Terms When the Debtor is Experiencing Financial Difficulties*
Should the exchange of new debt for existing debt with the same creditor (at terms which are lower than the prevailing market rate) be considered an extinguishment of debt by the debtor?

Marketable Securities

86-40 *Investments in Open-End Mutual Funds That Invest in U.S. Government Securities*
Should investments in mutual funds that hold debt securities be accounted for at the lower of cost or market or amortized cost?

Income Taxes

87-8 *Tax Reform Act of 1986: Issues Related to the Alternative Minimum Tax*
How should the alternative minimum tax be accounted for under Accounting Principles Board (APB) Opinion No. 11 and SFAS Nos. 96 and 109?

88-4 *Classification of Payment Made to IRS to Retain Fiscal Year*
How should partnerships and Subchapter S corporations record payments made to the IRS to retain their fiscal year?

91-8 *Application of FASB Statement No. 96 to a State Tax Based on the Greater of a Franchise Tax or an Income Tax*
How should a state franchise tax that is partly based on an income tax be accounted for under SFAS Nos. 96 and 109?

Insurance

88-5 *Recognition of Insurance Death Benefits* (consensus reached on issue No. 1 only)
May income from death benefits on corporate-owned life insurance policies be recorded immediately on an actuarially expected basis rather than deferred until the insured's death?

Inventory

86-46 *Uniform Capitalization Rules for Inventory Under the Tax Reform Act of 1986*
Are the type of costs that must be allocated to inventory for tax purposes also capitalizable under GAAP?

Leases

88-10 *Costs Associated with Lease Modification or Termination* (consensuses reached on issue Nos. 2 and 3 only)
When should costs associated with lease modification or termination be expensed?

Nonmonetary Transactions

86-29 *Nonmonetary Transactions: Magnitude of Boot and the Exceptions to the Use of Fair Value*
Should the magnitude of boot affect whether an exchange of nonmonetary assets is accounted for at the recorded amounts or fair value?

87-29 *Exchange of Real Estate Involving Boot*
Does SFAS No. 66 apply to exchanges of similar real estate involving boot that is at least 25% of the fair value of the exchange?

Real Estate

86-7 *Recognition by Homebuilders of Profit from Sales of Land and Related Construction Contracts*
How does SFAS No. 66 apply to the combined sale of land and building constructed by the seller under a construction contract?

88-24 *Effect of Various Forms of Financing under SFAS No. 66*
How should profit be recognized under SFAS No. 66 when a real estate transaction involves various forms of financing?

Revenue Recognition

88-18 *Sales of Future Revenues*
Should cash received in exchange for a promise to pay future revenues from a segment, product line, or other asset be classified as debt or deferred income? How should any foreign currency effects be recognized?

1.506 Selected EITF Consensuses Adopted Between March 15, 1992 and July 21, 1995

Business Combinations

93-7 Uncertainties Related to Income Taxes in a Purchase Business Combination
Is SFAS No. 38 on preacquisition contingencies applicable to income tax uncertainties and, if not, how should they be accounted for under SFAS No. 109?

95-3 Recognition of Liabilities in Connection with a Purchase Business Combination
In a purchase business combination, when should (1) costs to exit an activity of an acquired company, and (2) involuntary employee termination benefits and relocation costs be accrued as liabilities under APB Opinion no. 16, *Business Combinations*? What additional financial statement disclosures should the employer make related to these charges?

Environmental Liabilities

93-5 Accounting for Environmental Liabilities
When should recoveries be considered in measuring the amount of a contingent liability relating to environmental matters? Under what circumstances may an environmental liability be discounted?

Financial Instruments

93-18 Recognition of Impairment for an Investment in a Collateralized Mortgage Obligation Instrument or in a Mortgage-Backed Interest-Only Certificate

What is the effect of FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*, on the measurement and recognition of impairment losses on certain mortgage-backed investments?

Foreign Exchange Translation

92-4 Accounting for a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary

When a foreign economy ceases to be highly inflationary, how should an entity account for the change in the foreign subsidiary's currency from the reporting currency to the local currency?

92-8 Accounting for the Income Tax Effects Under FASB Statement No. 109 of a Change in Functional Currency When an Economy Ceases to Be Considered Highly Inflationary

Follow-up to Issue No. 92-4. Should the deferred taxes on the temporary differences arising from this type of change in functional currency be reflected as an adjustment to the cumulative translation adjustment component of stockholders' equity?

Income Taxes

93-12 Recognition and Measurement of the Tax Benefit of Excess Tax-Deductible Goodwill Resulting from a Retroactive Change in Tax Law

When an institution elects to retroactively amortize goodwill in accordance with the Omnibus Budget Reconciliation Act of 1993, how is the tax benefit related to tax-deductible goodwill in excess of "book" goodwill determined? How should that benefit be recognized under FASB Statement No. 109, *Accounting for Income Taxes*?

93-13 Effect of a Retroactive Change in Enacted Tax Rates That Is Included in Income from Continuing Operations

Should the tax effect of a retroactive change in enacted tax rates for the period that includes the enactment date of the change be measured using temporary differences existing at the date of enactment or those existing at the effective date of the tax rate change?

94-10 Accounting by a Company for the Income Tax Effects of Transactions among or with its Shareholders under FASB Statement No. 109, *Accounting for Income Taxes*

Should tax effects caused by transactions among or with shareholders be included in the income statement or in equity in the separate financial statements of the company affected?

95-10 Accounting for Tax Credits Related to Dividend Payments in Accordance with FASB Statement No. 109, *Accounting for Income Taxes*

Certain foreign jurisdicitons tax corporate income at different rates depending on whether that income is distributied to shareholders. Should a deferred tax asset be recognized (in the financial statements of a company that pays dividends subject to the tax credit to its shareholders) for the tax benefits of future tax credits that will be realized when income previously taxed at the undistributed rate is subsequently distributed?

Leases

93-8 Accounting for the Sale and Leaseback of an Asset That Is Leased to Another Party

How does a seller-lessee account for a sale/leaseback of personal property when the asset is subject to an operating lease at the time of sale or is subleased or intended to be subleased by the seller-lessee to a third party under an operating lease?

Nonmonetary Transactions

93-11 Accounting for Barter Transactions Involving Barter Credits

Does APB Opinion No. 29, *Accounting for Nonmonetary Transactions*, apply to an exchange of a nonmonetary asset for barter credits?

Postretirement Benefits Other Than Pensions

93-3 Plan Assets Under FASB Statement No. 106

If a trust is established to pay postretirement benefits, must the trust assets be "bankruptcy-proof" to qualify as plan assets under SFAS No. 106?

Restructuring Charges

94-3 Accounting for Restructuring Charges

When should a liability be recognized for costs of termination benefits, as defined in the consensus, to be provided to involuntarily terminated employees? What related disclosures should be made for all periods until the termination plan is completed? (Note: At press time, the EITF had reached consensuses on only selected issues relating to restructuring charges. Remaining issues will be discussed and additional consensuses may be reached at future meetings. Therefore, practitioners should consult the looseleaf edition of *EITF Abstracts* or call the AICPA Technical Hotline to obtain current information on this issue.)

Debt Restructuring

94-8 Accounting for Conversion of a Loan into a Debt Security in a Debt Restructuring

In a debt restructuring, if there is a difference in the basis in the loan being restructured and the fair value of the debt security received, what should be the creditor's initial cost basis of a debt security received from the original debtor in a loan restructuring and how should the creditor account for any differences between the basis in the loan and the fair value of the security at the date of the restructuring?

Revenue Recognition

95-4 Revenue Recognition on Equipment Sold and Subsequently Repurchased Subject to an Operating Lease

Is a manufacturer precluded from recognizing a sale of a product to a dealer if the customer subsequently enters into an operating lease with the manufacturer or its finance affiliate who acquires that product subject to a lease?

Transfer of Receivables With Recourse

92-2 Measuring Loss Accruals by Transferors for Transfers of Receivables With Recourse

When receivables are sold with recourse, should the transferor accrue all probable credit losses over the life of the transferred receivables at the sale date? May the recourse obligation be discounted if the timing of the cash flows can be reasonably estimated?

Stock Options

94-6 Accounting for the Buyout of Compensatory Stock Options

When compensatory stock options are repurchased by the issuing company, how should the total amount of compensation cost recognized as expense be determined?

1.507 Practitioners may obtain the *EITF Abstracts* by calling the FASB Order Department at (203) 847-0700.

1.600 GENERALLY ACCEPTED AUDITING STANDARDS

1.601 SAS No. 1, *Codification of Auditing Standards and Procedures*, developed by the AICPA in 1947 and continuously modified, contains:

General standards:

1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the audit and the preparation of the report.

Standards of field work:

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.

2. A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of reporting:

1. The report shall state whether the financial statements are presented in accordance with GAAP.

2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.

4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

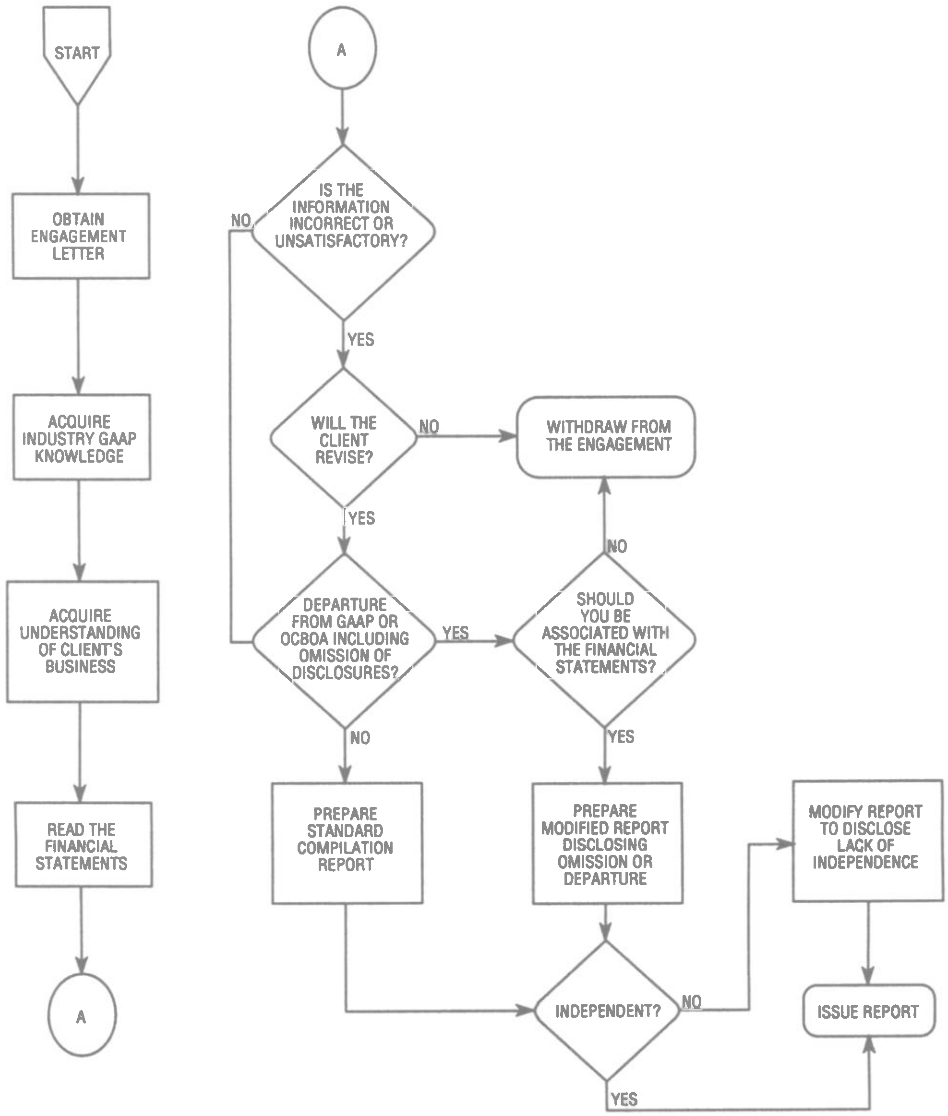
These standards are the framework for auditing guidance included in the statements on auditing standards issued by the Auditing Standards Board of the AICPA.

Standards for Accounting and Review Services

1.602 The AICPA's Accounting and Review Services Committee provides guidance for compilation and review services in its statements on accounting and review services and related interpretations. Illustration Nos. 1-2 and 1-3 outline the standards for compilation and review services. A full discussion of the performance and reporting requirements for compilation and review engagements are contained in Chapters 4 and 20 of this Manual.

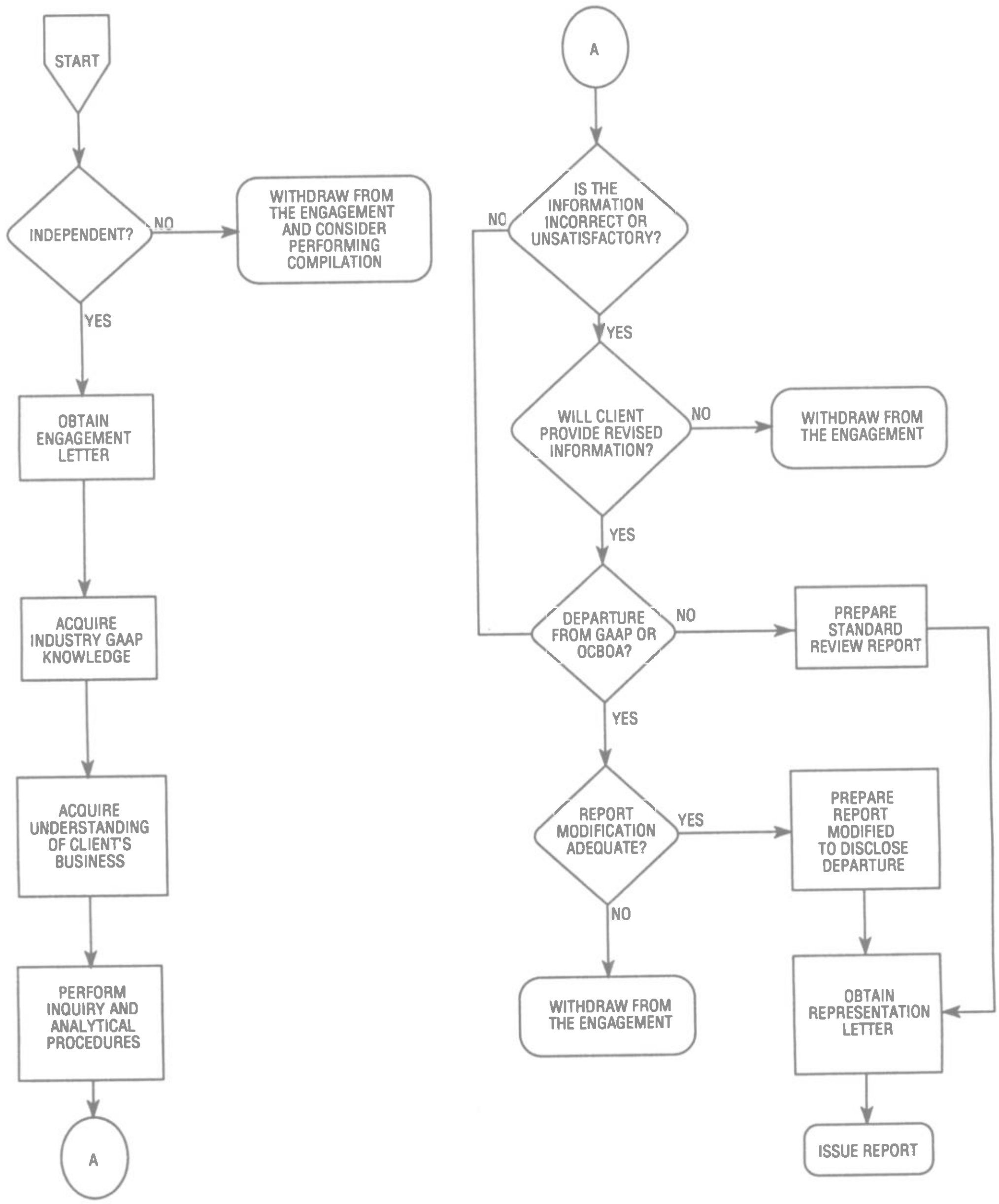
Flowchart for Performing Compilation Services

ILLUSTRATION NO. 1-2



Flowchart for Performing Review Services

ILLUSTRATION NO. 1-3



1.700 FIRM POLICIES AND PROCEDURES

1.701 This Manual incorporates the authoritative guidance in the professional standards discussed above. These standards represent minimum levels of guidance. Common sense and professional judgment must also be applied to each individual circumstance. Policies and procedures regarding engagement performance are included in Chapters 1 through 8. The Manual contains firm policies and procedures that the staff is expected to apply uniformly on all engagements. Deviation from firm policies and procedures must be documented by the in-charge and approved by the engagement partner.

Quality Control Standards

1.702 The AICPA Statement on Standards for Quality Control (SQCS) No. 1, *System of Quality Control for a CPA Firm*, requires firms to establish and maintain a quality control system to provide reasonable assurance that the firm will meet professional standards in its accounting and auditing engagements, and to undergo a peer review.

1.703 SQCS No. 1 requires that firms consider the need for quality control policies and procedures for the following nine elements:

- Independence — All staff should maintain independence as required by the AICPA rules of conduct.
- Assigning personnel to engagements — All staff should have the applicable training and proficiency.
- Consultation — Staff should seek assistance from knowledgeable sources, as necessary.
- Supervision — Work should be performed in conformity with the firm's standards and with professional standards.
- Hiring — Staff should be competent, motivated, and possess integrity.
- Professional development — Staff should be adequately trained to fulfill their responsibilities.
- Advancement — Staff should know nature of current duties as well as what it takes to progress professionally in the firm.
- Acceptance and continuance of clients — Policies should provide reasonable assurance that likelihood of association with a client whose management lacks integrity is minimized.
- Inspection — To provide reasonable assurance that the procedures relating to the eight other elements are being applied effectively.

1.704 Each firm should establish the quality control policies and procedures that are appropriate for its practice and organizational structure. Large firms will generally have elaborate policies and procedures for all nine elements. Small firms will have less extensive policies and procedures, and in some cases, will find that one or more of the nine elements do not apply to their practices.

Practice Tip:

An AICPA task force has been formed to study possible changes to SQCS No. 1 and its Interpretations. Recommendations include changing the existing quality control element of inspection to "monitoring" (monitoring activities include, but are not limited to inspection), combining the existing elements of hiring, assignment of personnel, professional development, and advancement into a single "personnel issues" quality control element, and combining the existing supervision and consultation elements into "engagement performance." The authors believe that, if adopted, such changes will clarify and streamline the existing pronouncement without necessitating any material changes in the quality control systems firms already have implemented. The authors also believe that any major revisions to SQCS No. 1 probably will need to go through the profession's due process before such revisions can be adopted. An exposure draft of an amendment to SQCS No. 1 is expected to be issued in the fall of 1995. In the meantime, SQCS No. 1, in its original form, should be regarded as the current authoritative standard in the area of quality control.

1.705 The programs, forms, and checklists in this Manual are designed to help firms meet the quality control elements related to performing audit, compilation, and review engagements. They should interface with the firm's other quality control policies and procedures related to other types of professional services and other administrative aspects of maintaining a quality practice. The AICPA publishes a companion product in the Integrated Practice System (IPS) of engagement manuals titled *Quality Control Manual for CPA Firms* that provides a thorough discussion for local and regional firms of how to establish and maintain a quality control system.[1] That Manual also provides numerous forms, checklists, and other documentation helpful to maintaining a quality control system.

Updating of This Manual

1.706 To provide the users of this Manual with the most current authoritative guidance, this Manual is updated annually. This edition has been updated to reflect the authoritative pronouncements, including related interpretations, through the following:

SAS No. 74
SSAE No. 3
SSARS No. 7
SFAS No. 122
SOP 95-1
Practice Bulletin 14
FASB Interpretation No. 41
FASB Technical Bulletin No. 94-1
EITF Consensuses adopted through May 1995

[1] The IPS *Quality Control Manual for CPA Firms* (Product No. 008867) can be obtained by calling the AICPA Order Department at (800) 862-4272.

1.707 Users should be alert for pronouncements issued subsequent to those listed above that could affect their audit, compilation, and review engagements.

References to Authoritative Literature

1.708 Throughout this Manual, references to the publications containing authoritative literature have been included to help users in performing research. The explanation of these references follows:

AC = references to the sections in FASB *Accounting Standards — Current Text*

AU = references to the sections in the AICPA *Professional Standards* — Volume 1

AT = references to the Attestation Standards in the AICPA *Professional Standards* — Volume 1

ET = references to the Code of Professional Conduct in the AICPA *Professional Standards* — Volume 2

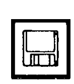
QC = references to the quality control standards in the AICPA *Professional Standards* — Volume 2

1.800 USE OF FORMS IN ELECTRONIC FORMAT

1.801 WordPerfect. Enclosed with this year's edition of the Manual is a complementary disk that contains the sample engagement letters, representation letters, sample auditor's reports, and other correspondence illustrated in this Manual. The documents in the disk are in WordPerfect format to allow you to easily customize them for each client.

1.802 Lotus 1-2-3. Also included on the complementary disk is the Summary of Possible Journal Entries Form in Lotus 1-2-3 (release 3.1 with wysiwyg or release 3.4 and higher). This file allows you to easily post unrecorded misstatements and it contains formulas to calculate totals and percentages. If you do not have access to Lotus 1-2-3, you may copy the Form included in section 10.302 of Chapter 10 for inclusion in your workpapers.

1.803 These documents are identified in the Manual by the following icon:



1.804 Audit Program Generator. Many subscribers to the Integrated Practice System (IPS) Engagement Manuals are also users of the AICPA's Audit Program Generator (APG), a specially designed software program that allows you to customize a variety of AICPA work programs and checklists for each client.

1.805 If you are already an APG user, you may purchase the Library Volume containing the programs and checklists included in this Manual. To order APG and/or the APG Libraries for the IPS Engagement Manuals, call the AICPA's Order Department at 1-800-862-4272, sub-menu #1. For APG product information, call the AICPA Software Connection at 1-800-226-5800.

1.806 The programs and checklists that are available in the APG Library Volume are identified by the following icon:

Audit Engagement Planning

CHAPTER 2

PRE-ENGAGEMENT CONSIDERATIONS AND AUDIT PLANNING

Table of Contents

Table of Contents (Continued)

Table of Contents (Continued)

CHAPTER 2

PRE-ENGAGEMENT CONSIDERATIONS AND AUDIT PLANNING

2.000 INTRODUCTION

2.001 In recent years, accountants who provide audit services have become increasingly aware of the importance of evaluating their relationships with prospective and continuing clients and the need to perform adequate planning in their engagements. This chapter discusses the requirements to perform client acceptance and continuance procedures and to adequately plan audit engagements. Also discussed are other pre-engagement considerations.

2.100 CLIENT ACCEPTANCE AND CONTINUANCE

2.101 Although most firms want to expand their client base, this expansion should be carefully monitored to ensure that accepting a prospective client and continuing a relationship with an existing client will not harm the firm's reputation and standing in the community.

2.102 The AICPA Statement on Quality Control Standards (SQCS) No. 1, *System of Quality Control for a CPA Firm*, requires CPA firms to establish a system of quality control. Included in a system of quality control should be policies and procedures for accepting and continuing clients. Specifically, paragraph 7 of SQCS No. 1 (QC 10.07) states:

> Policies and procedures should be established for deciding whether to accept or continue a client in order to minimize the likelihood of association with a client whose management lacks integrity.

2.103 Firms should develop, preferably in writing, quality control policies and procedures for evaluating new and existing client relationships that meet its unique organizational and operating characteristics. These policies should specify:

For prospective clients

- The procedures to be followed for evaluating a prospective client, including
  - obtaining and reviewing the prospective client's available financial statements or information.
  - inquiring of third parties, such as the prospective client's attorney's, bankers, etc. about the entity and its management.
  - communicating with the predecessor auditor or accountant.
  - considering circumstances that would require special attention or that present special risks in the engagement.

  - evaluating the firm's independence and ability to serve the prospective client.
  - determining whether accepting the client would violate any applicable regulatory agency requirements or the ethics codes of the AICPA or state CPA society.
- The individuals responsible for evaluating prospective clients and making acceptance decisions, and for approving such decisions.
- How appropriate firm personnel are informed of the policies and procedures for accepting clients.
- The individuals responsible for administering and monitoring compliance with the firm's policies and procedures.

For continuing clients

- The procedures followed for evaluating relationships with continuing clients, such as:
  - considering whether significant changes have occurred since the last engagement, such as changes in management, legal counsel, financial condition, or scope of the engagement.
  - considering whether any conditions exist that would have caused the firm to reject the client had they been known at the time of initial acceptance.
- The frequency of such evaluations.
- The individuals responsible for evaluating continuing clients, for deciding whether to continue relationships with existing clients, and for approving such decisions.
- How firm personnel are informed of the firm's continuance policies and procedures.
- The individuals responsible for administering and monitoring compliance with the policies and procedures.

2.104 The Client Acceptance and Continuance Form in Chapter 10, section 10.000 is designed to address the basic policies and procedures mentioned above for both new and continuing clients. Sections 2.105 and 2.115 provide detailed discussions of two important considerations included in the Client Acceptance and Continuance Form: evaluation of overall engagement risk and ensuring that the firm and firm personnel are independent with respect to the client.

Overall Engagement Risk

2.105 Engagement risk for a client has the following primary components:

- Integrity of management
- Use of financial statements
- Auditability of the entity
- Business environment

2.106 Integrity of Management. Statement on Auditing Standards (SAS) No. 58, *Reports on Audited Financial Statements,* states, "The financial statements are the responsibility of management." SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities,* states, "The auditor neither assumes that management is dishonest nor assumes unquestioned honesty." SAS No. 53 also states, "Management integrity is important because management can direct subordinates to record transactions or conceal information that can materially misstate financial statements."

2.107 The integrity of management should be evaluated as part of the client acceptance or retention decision on the Client Acceptance and Continuance Form (Chapter 10, section 10.000). Approval of the Client Acceptance and Continuance Form by designated partners indicates that the integrity of management is considered adequate.

2.108 Any significant matters related to management's integrity, arising during the planning and performance of the audit, should be documented in a special memorandum containing a description of:

- The matters designated for further consideration.
- The risk of material misstatement to the financial statements.
- The additional or changed auditing procedures considered necessary to mitigate such risks.
- The results of performing such procedures and their effects on the audit report.

2.109 Use of Financial Statements. The risk associated with the use of financial statements is usually high because auditors cannot control their ultimate distribution or the purposes for which users rely on them. The risk is even higher in circumstances such as the following:

- Statements used in legal proceedings.
- Statements used for price-setting in purchases, sales, or mergers.
- Statements of construction contractors submitted to bonding underwriters.
- Statements used to obtain credit.

2.110 The use of financial statements should be documented annually on the Client Acceptance and Continuance Form.

2.111 Auditability of the Entity. A firm should consider the auditability of the entity prior to deciding whether to accept or retain a client. Although a potential client may request an audit and users of the financial statements may require an audit, certain factors may preclude an auditor from being able to express an opinion on the financial statements.

2.112 If a client's accounting system does not provide sufficient evidence to support the recorded transactions, or if the client's accounting records have been destroyed or lost, the entity may be unauditable.

2.113 For a new client, auditability can usually be determined through discussions with management and the predecessor auditor. The auditor should inquire as to the accounting system and how management determines that the policies and procedures for processing financial information are followed. For a continuing client, auditability is determined by discussions with management as well as through prior experience.

2.114 Business Environment. The auditor should also consider the business environment in which the client operates. Is the nature of the client's business one which the firm does not have the requisite expertise? Is the client in a financial position where bankruptcy, takeover or merger, or sudden collapse could occur? All of these concerns should be addressed when an auditor decides on accepting or retaining a client.

Other Engagement Matters

2.115 Other matters the auditor should consider when the client acceptance and retention is made are:

- Potential for going-concern problems, and
- Independence

2.116 Potential for Going-Concern Problems. Financial reporting is based on the assumption that the entity will continue as a going concern, unless there is significant information to the contrary. SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AU 341), requires the auditor to evaluate the client's ability to continue as a going concern for a period not to exceed one year beyond the balance-sheet date. To perform this evaluation, the auditor is not required to design audit procedures to detect going-concern problems; rather, the evaluation should be based on information obtained during the course of the audit about conditions or events that indicate that there is substantial doubt about the entity's ability to continue as a going concern. Examples of such conditions or events are negative cash flows, defaults on loan agreements, contraction of service levels, legal proceedings, and operating difficulties.

2.117 If the auditor concludes that there is substantial doubt about the entity's ability to continue as a going concern, he or she should:

- Consider management's plans to mitigate the effects of the condition or event, and
- Assess the likelihood that the plans can be effectively implemented.

2.118 If substantial doubt remains after evaluating management's plans, the auditor should:

- Consider the adequacy of financial statement disclosures about the going-concern problem, and
- Include an explanatory paragraph in the auditor's report to reflect his or her conclusion that there is substantial doubt about the entity's ability to continue as a going concern.

2.119 Whenever the auditor becomes aware of conditions or events that cause him or her to believe that there may be substantial doubt about an entity's ability to continue as a going concern, he or she should document the condition or event, the procedures followed to reach a conclusion about whether substantial doubt exists and, if applicable, the effect on the auditor's report and financial statements. If questions about an entity's ability to continue as a going concern arise in performing pre-engagement and audit planning procedures, they should be documented in the Client Acceptance and Continuance Form and the Audit Planning Memorandum. Questions identified during engagement performance should be documented in a special memorandum that includes a discussion of:

1. The nature of the condition or event that raises a going-concern question.

2. The evaluation of management's plans and other factors, and related audit evidence, that might either mitigate or aggravate the condition or event.

3. The assessment of whether substantial doubt exists about the entity's ability to continue as a going concern.

4. The evaluation of the adequacy of financial statement disclosures of the matters giving rise to the information indicating a going-concern problem and management's plans to mitigate the problem.

5. Any modifications to the auditor's report considered necessary for the uncertainty.

2.120 The following are some conditions and events that may raise a question about an entity's ability to continue as a going concern:

- Recurring operating losses
- Working capital deficiencies
- Default on loans or similar agreements
- Restructuring of debt
- Substantial dependence on the success of a particular project
- Legal proceedings, legislation, or similar matters that might jeopardize a entity's ability to operate
- Loss of a key customer or supplier

2.121 As mentioned above, if the auditor becomes aware of any of these conditions during the course of the audit, he or she should consider calculating the Altman Z Score, which is another indicator of an entity's health and its ability to continue as a going concern. A brief discussion of the Altman Z Score is presented in sections 2.122-2.126. A sample form is presented in Chapter 10, section 10.304.

2.122 **Altman Z Score.** The Altman Z Score, developed by Edward I. Altman,* is a composite formula that is widely used to measure the financial health of a company. The formula takes financial ratios and multiplies each by a specific constant. The computed amounts then are added together to obtain an overall score. If the total Z Score determined under this calculation exceeds 2.6, the entity probably can be considered sound and secure. If less than 1.1, long-range survival prospects may be in question.

2.123 The Z Score can be computed on the Altman Z (Zeta) Score Calculation Form in Chapter 10, section 10.304. This score then is compared to scores from other entities to rate relative financial health. Also, the trend of the Z Score should be analyzed to determine whether or not a problem may be developing.

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* Source: Altman, Edward, *Corporate Financial Distress: A Complete Guide to Predicting, Avoiding, and Dealing with Bankruptcy*, 1983, John Wiley & Sons.

2.124 Practitioners should consider calculating the Z Score when they become aware of the conditions and events listed in Chapter 2, section 2.120 that may raise a question about the entity's ability to continue as a going concern.

2.125 Because the Z Score is only one means of measuring an entity's financial health, a CPA firm's quality control policies and procedures should indicate under what conditions, if any, the auditor would make this calculation.

2.126 The results of the Z Score would be documented in the Client Acceptance and Continuance Form and in the Audit Planning Memorandum.

2.127 **Independence.** Auditors must be independent of a client to be able to express an opinion on the financial statements. SQCS No. 1 contains a requirement that firms establish quality control policies and procedures that ensure compliance with the professional requirements concerning independence. Specifically, paragraph 7 of this Statement states:

> Policies and procedures should be established to provide the firm with reasonable assurance that persons at all organizational levels maintain independence to the extent required by the rules of conduct of the AICPA. Rule 101 of the rules of conduct (ET section 101) contains examples of instances wherein a firm's independence will be impaired.

2.128 Also, the AICPA's *Code of Professional Conduct* "Objectivity and Independence" (ET section 55), states:

> A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.

2.129 In addition to the basic independence rule found in the *Code of Professional Conduct* are independence interpretations and rulings that address specific situations encountered by accountants. The following are three independence rulings, found in ET Section 191, that have wide applicability. However, accountants should be familiar with all of the independence rules, interpretations, and rulings.

- Ethics Ruling 191.1, "Acceptance of a Gift" (ET 191.001-.002), indicates that a member may not accept more than a token gift from a client.
- Ethics Ruling 191.3, "Members as Signer or Cosigner of Checks" (ET 191.005-.006), indicates that a member may not accept responsibility of signing or cosigning checks.
- Ethics Ruling 191.4, "Payroll Preparation Services" (ET 191.007-.008), indicates that a member may not perform payroll preparation services for a client if the member is a signer or cosigner of the checks and the member's bank account is used.

2.130 These independence requirements apply not only to AICPA members, but to their spouses and dependents as well. Independence of a member or a member's firm is generally not impaired solely because the member's spouse or a dependent is employed by the client, as long as the employment is in a position that does not allow significant influence over the organization's operating, financial, or accounting policies. However, if the employment is in a position in which the person's activities are audit-sensitive (normally an element of or subject to significant internal accounting controls, such as cashier, internal auditor, or accounting supervisor), the auditor's independence would be impaired.

2.131 In addition to establishing policies and procedures to ensure that firms have adequate procedures to determine that their personnel are independent with respect to their clients, the authors believe it is advisable to also ensure that potential independence impairments have been identified and resolved before each engagement begins. As a result, the Client Acceptance and Continuance Form requires that this determination be made on each engagement before deciding to accept a new client or continue a relationship with an existing client.

Practice Tip:

All practitioners, and the members of their professional staffs, must be thoroughly familiar with the Code of Professional Conduct, the interpretations of ET section 55 that appear in ET section 101, and the related individual rulings that appear in ET section 191 ("Ethics Rulings on Independence, Integrity, and Objectivity").

Using the Client Acceptance and Continuance Form

2.132 The Client Acceptance and Continuance Form (Chapter 10, section 10.000) is designed to help firms evaluate prospective clients and to reevaluate existing clients. It provides documentation of the evaluation process for new and existing clients, the decision to accept and continue clients, and approval of the decision to accept and continue clients. This Form should be modified as necessary to interface with the firm's quality control policies and procedures for acceptance and continuance of clients.

2.133 For prospective clients, Part I of the Client Acceptance and Continuance Form should be completed by the in-charge and approved by the engagement partner. Part II should be completed by the engagement partner and approved by the partner responsible for approving new clients.

2.134 For existing clients, the in-charge should update and revise the form, as necessary, to evaluate the desirability of continuing the relationship with the client. Multi-year sign-off space is provided to document an annual evaluation and the engagement partner's approval of the continuance (or discontinuance) decision.

2.200 ENGAGEMENT LETTERS

2.201 Adequate engagement planning includes communicating an understanding of the nature of the firm's services, timing of field work, report deadlines, responsibilities of the client, and methods of fee determination and payment. The engagement partner should confirm, at least annually, an understanding of the nature of the engagement and the extent of the reporting responsibilities before beginning field work. Such communication will normally include an appropriate engagement letter and a pre-engagement client conference.

2.202 Currently, there are no authoritative pronouncements requiring a written engagement letter for an audit, although most firms regard their completion as good business practice. An engagement letter helps to prevent misunderstandings between the entity and the auditor regarding the services to be provided, including the limitations. The engagement letter also sets forth the responsibilities of the client, and in most states it becomes a legally binding contract on both parties. There are other good reasons to obtain an engagement letter, including the following:

- *Reduce the risk of litigation.* Misunderstandings with clients regarding the nature and limitations of the services provided can result in litigation.
- *Avoid misunderstandings by the staff.* The staff performing the work can review the engagement letter to obtain a clear understanding of the services to be provided and the required timing of issuance of the report.

Practice Tip:

Be careful when using a proposal or preliminary engagement letter for a client. If the letter describes additional services that are not finally agreed upon, it may be used in litigation as an indication of inadequate performance by you on the engagement. You should also make sure that a final engagement letter is always issued in such circumstances.

2.203 The letter should be prepared by the in-charge before any significant work takes place on the engagement. The in-charge should personally present the letter to the client to ensure that a complete understanding has been achieved. The signed copy should be filed with the current engagement working papers.

2.204 Should the nature of an engagement change during its progress, or should the firm be engaged for additional services during the year, a new engagement letter should be prepared. A step up from a compilation to an audit engagement and a special engagement for preparing a budget and cash flow forecast are examples of changes that would require a new engagement letter.

2.205 Chapter 13, sections 13.024 – 13.026, provides examples of engagement letters for audit, review, and compilation engagements.

Using Engagement Letters to Minimize Liability to Third Parties

2.206 The AICPA's task force on accountant's legal liability developed guidance on using engagement letters to minimize liability to third parties. The task force concluded that clarifying language added to an engagement letter may be useful in states in which the courts adhere to the privity concept of liability to third parties. This clarifying language should identify third parties that are known by the accountant to be negotiating or contemplating a transaction with the client, and who will be obtaining a copy of the financial statements. An example of such language is as follows:

> We understand that you are negotiating with XYZ Bank for a loan in the amount of $25,000 and the purpose of our report on your financial statements is to enable you to present the audited financial statements to XYZ Bank. We are not aware of any other persons, entities or limited groups of persons or entities for whose use or benefit this report is intended or contemplated.

Practice Tip:

In the authors' opinion, the clarifying language in section 2.206 added to an engagement letter is of questionable effectiveness in minimizing legal liability. However, if you decide to use it, you should consult with legal counsel to get advice on the specific wording that may be effective for your particular state.

2.207 The authors of this manual recommend that auditors try to avoid issuing privity letters. However, this is not always practical, particularly when the client's interests will be adversely affected. With this in mind, the following are some guidelines the authors recommend for auditors who must provide a privity letter:

1. Name the third party that has informed the auditor that it intends to rely on the financial statements.
2. Address the third party's responsibilities to undertake an investigation and due diligence review of the financial statements and condition of the company or to retain other professionals to assist it in that effort.
3. Do not merely acknowledge a third party's intended reliance, but identify the various ways in which that reliance is qualified. This can be accomplished by asking the third party to provide a letter stating that it has performed other due diligence procedures, or by stating in the privity letter that the auditor assumes that the third party has performed due diligence procedures.
4. Acknowledge the third party's *intention* to rely, not the actual reliance. Make it clear that you do not expect the third party to rely solely on your report on the financial statements as the basis for its decision.
5. Contrast the scope of the work and level of assurance provided with the level of assurance and scope of an audit.

6. State, as precisely as possible, the purpose of the third party's reliance. Avoid comments about the third party's intended after-the-fact general reliance.

2.208 An auditor, contemplating use of a privity letter, should consult with legal counsel regarding its effectiveness in minimizing legal liability in the auditor's particular state. Because legal requirements vary from state to state, the auditor also should consult with legal counsel regarding the appropriate content of the letter.

2.300 AUDIT PLANNING

2.301 Professional standards include many general and specific planning requirements. The two basic requirements to plan engagements are:

(1) The third General Standard of Rule 201 of the AICPA *Code of Professional Conduct* states, "A member shall adequately plan and supervise professional services."

(2) The first standard of generally accepted auditing standards (GAAS) requires that "the work is to be adequately planned and assistants, if any, are to be properly supervised."

2.302 SAS No. 22, *Planning and Supervision* (AU 311), provides specific guidance to the independent auditor performing an audit in accordance with GAAS, including preparing an audit program and obtaining an understanding of the organization's operations. Many other SASs also require consideration of matters such as potential misstatements, continued existence of the entity, accounting estimates, obtaining an understanding of the internal control structure, and preliminary materiality considerations.

2.303 Audit planning is also affected by the following AICPA auditing standards:

1. SAS No. 22, *Planning and Supervision*
2. SAS No. 31, *Evidential Matter*
3. SAS No. 39, *Audit Sampling*
4. SAS No. 41, *Working Papers*
5. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*
6. SAS No. 48, *The Effects of Computer Processing on the Examination of Financial Statements*
7. SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*
8. SAS No. 54, *Illegal Acts by Clients*
9. SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*
10. SAS No. 56, *Analytical Procedures*
11. SAS No. 57, *Auditing Accounting Estimates*
12. SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*
13. SAS No. 67, *The Confirmation Process*
14. SAS No. 70, *Reports on the Processing of Transactions by Service Organizations*
15. SAS No. 73, *Using the Work of a Specialist*

2.304 Achieving both engagement quality and profitability requires extensive planning. Engagement planning should begin well before the balance-sheet date and continue until completion of the engagement. The engagement partner should be involved at strategic times during the planning, performance, and completion of an engagement. Early and frequent executive involvement in program design and in related judgment decisions will help develop the in-charge and other staff personnel, will identify problems before the engagement begins, and will result in a high-quality, profitable engagement.

2.305 Complying with all applicable professional standards and achieving maximum audit engagement profitability can only be accomplished through effective planning. Effective planning for audits must include, among other things, these four basic audit planning activities:

1. Obtain an understanding of the entity's internal control structure.
2. Determine the level of overall engagement risk, risks of potential misstatements, and the overall materiality limit.
3. Make judgments about the staffing of the engagement, the extent of supervision, and the degree of professional skepticism.
4. Decide on the most cost-beneficial audit approach based on the risk assessment and materiality decisions.

Obtain an Understanding of the Internal Control Structure

2.306 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, requires that auditors obtain an understanding of the client's internal control structure sufficient to plan the audit. Paragraph 16 of SAS No. 55 (AU 319.16) states:

> The auditor should obtain a sufficient understanding of each of the three elements of the entity's internal control structure [the control environment, accounting system, and control procedures] to plan the audit of the financial statements. The understanding should include knowledge about the design of relevant policies, procedures, and records and whether they have been placed in operation by the entity. In planning the audit, such knowledge should be used to—
>
> - Identify types of potential misstatements.
> - Consider factors that affect the risk of material misstatements.
> - Design substantive tests.

2.307 This understanding is required in all audits. Completion of the Internal Controls Questionnaire (section 10.200) provides a basis for obtaining an understanding of the client's internal control structure sufficient to plan the audit using the ABC System. Completion of the All-Substantive Approach Questionnaire (section 10.200) provides a basis for obtaining an understanding of the client's internal control structure using the All-Substantive Approach.

Risk of Potential Misstatements

2.308 The risk that potential misstatements will occur results primarily from weaknesses in the internal control structure, inherent risks in certain transactions or account balances, material and unusual account balances, and the entity's history of misstatements. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit,* refers to these risks as inherent and control risks. SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities,* refers to these errors and irregularities as unintentional and intentional misstatements of financial statements, respectively. These risks will be evaluated and documented on the following forms which are included in Chapter 10 of this Manual:

- ABC Approach: Internal Controls Questionnaire, Planning Matrix, Risk of Potential Misstatements Evaluation Form, and Tests of Controls Programs.
- All-Substantive Approach: All-Substantive Approach Questionnaire and Tests of Controls Programs (System C).

The level of risk of potential misstatements will directly affect the desired level of assurance in the affected transaction or balance. High risk requires a higher level of assurance, which requires more evidence. Low risk means less evidence is necessary.

Errors and Irregularities

2.309 SAS No. 53 (AU 316) requires auditors to assess the risk that errors and irregularities that have a material effect on the financial statements could occur, and to design and perform the audit to obtain reasonable assurance that such errors and irregularities will be detected during the audit. It also discusses the impact of errors and irregularities on the auditor's report, and the auditor's requirement to communicate errors and irregularities to the audit committee or its equivalent.

2.310 Paragraph 2 of SAS No. 53 (AU 316.02) defines errors as "*unintentional* misstatements or omissions of amounts or disclosures in financial statements." In paragraph 3 (AU 316.03), irregularities are defined as "*intentional* misstatements or omissions of amounts or disclosures in financial statements." Because irregularities are intentional (and, as a result, may involve forgery or collusion), they usually are more difficult to detect than errors.

2.311 Because auditors' opinions are based on the concept of reasonable assurance, they cannot guarantee that financial statements are free from material misstatements due to errors and irregularities. However, they must exercise due care in planning, performing, and evaluating the results of the audit and must apply the appropriate level of professional skepticism to achieve reasonable assurance that the material errors and irregularities will be detected.

2.312 As part of audit planning, auditors should assess the risk that errors and irregularities may cause the financial statements to be materially misstated. The auditor's concern about the risk of material misstatements is either heightened or mitigated by the auditor's understanding of the internal control structure.

2.313 SAS No. 53 (AU 316.10) cites a number of management, operational, industry, and engagement characteristics that might cause the auditor to believe that there is an increased risk that material errors and irregularities could occur. Examples of these characteristics are listed below:

- Management's attitude towards financial reporting is unduly aggressive.
- Operating and financing decisions are dominated by a single person.
- Management places undue emphasis on meeting earnings projections.
- The entity operates in a declining industry, with many business failures.
- Many contentious or difficult accounting issues are present.
- Significant and unusual related-party transactions or balances are present.

- Internal or external matters exist that raise substantial doubt about the entity's ability to continue as a going concern.

2.314 Completing or updating the Client Acceptance and Continuance Form, the Audit Planning Memorandum, the Internal Controls Questionnaire or the All-Substantive Approach Questionnaire, and the Risk of Potential Misstatements Evaluation Form provide a basis for assessing the risk that material errors and irregularities could occur.

Design of the Audit

2.315 Based on this assessment, the auditor should design the audit to provide reasonable assurance of detecting errors and irregularities that could have a material effect on the financial statements. This strategy might involve placing more experienced staff on the engagement, increasing supervision and review of assistants' work, testing more items, performing procedures at year end rather than at interim dates, or modifying the nature of auditing procedures to obtain more reliable evidential matter.

Evaluating the Audit Test Results

2.316 Auditors are accustomed to evaluating the impact of differences between the client's accounting records and the auditor's findings. This evaluation is emphasized in SAS No. 53 because irregularities have implications beyond their direct monetary effects.

2.317 SAS No. 53 requires that when the auditor concludes that a potential audit adjustment is related to an irregularity, but is not material to the financial statements, he or she should refer the matter to at least one level of management above those involved in the irregularity, and should be satisfied that the irregularity has no implications on other aspects of the audit. An example of an irregularity that would generally not be material to the financial statements is a misappropriation of petty cash.

2.318 If the auditor believes that the irregularity is or could be material to the financial statements, he or she should:

1. Consider the implications for other aspects of the audit.
2. Discuss the matter and the approach to further investigation with an appropriate level of management at least one level above those involved.
3. Attempt to obtain sufficient competent evidential matter to determine whether, in fact, material irregularities exist and, if so, their effect.
4. If appropriate, suggest that the client consult with legal counsel on matters concerning questions of law.

Effect of Irregularities on the Auditor's Report

2.319 If financial statements affected by a material irregularity are not revised, the auditor should express either a qualified or adverse opinion, explaining all substantive reasons for the opinion. If the auditor is unable to perform necessary auditing procedures related to the irregularity, or if the auditor is unable to reach a conclusion about the financial statement effect of the irregularity, he or she should issue a disclaimer of opinion, or a qualified opinion due to a scope limitation. If management refuses to accept a modified auditor's opinion due to an irregularity, the auditor should withdraw from the audit.

2.320 In any event, the auditor should ensure that matters involving errors and irregularities are communicated to the audit committee or its equivalent. The auditor should consider whether an understanding as to disclosure of any errors or irregularities discovered should be addressed in the engagement letter.

Illegal Acts

2.321 SAS No. 54, *Illegal Acts by Clients* (AU 317), prescribes the nature and extent of consideration an auditor should give to the possibility that the client has committed illegal acts, and also provides guidance on the auditor's responsibilities when a possible illegal act is detected.

2.322 Paragraph 2 of SAS No. 54 (AU 317.02) defines illegal acts as "violations of laws or governmental regulations. Illegal acts by clients are acts attributable to the entity whose financial statements are under audit or acts by management or employees acting on behalf of the entity." Determining whether an act is illegal is normally beyond the auditor's professional competence and would generally be based on an attorney's advice or on the findings of a court of law.

2.323 Of key importance to applying SAS No. 54 is an understanding of the difference between direct and indirect effects of laws and regulations. Direct-effect laws and regulations are those that affect financial statement line items. For example, federal tax laws directly affect the amounts of income tax expense and accruals reported in the financial statements. Indirect-effect laws and regulations are those that relate more to the entity's operations than to its financial statements, such as occupational safety and health and equal employment. While violations of these laws do not directly affect financial statement line items, they can result in monetary fines, penalties and damages that could require adjustment to or disclosure in the financial statements. Understanding these two concepts is important because the auditor's responsibilities to detect and report direct-effect laws and regulations in a GAAS audit are different from the responsibilities to detect indirect-effect laws and regulations. Specifically, the auditor's responsibility to detect misstatements from illegal acts that have a direct and material effect on the financial statements is the same as for irregularities as described in SAS No. 53 (discussed in sections 2.319–2.320). SAS No. 54 discusses illegal acts related to indirect-effect laws and regulations (hereinafter called simply "illegal acts").

2.324 SAS No. 54 does not require the auditor to design tests to detect illegal acts; however, the auditor must be aware that illegal acts may have occurred and must perform certain audit procedures to confirm the existence of illegal acts if such specific evidence is discovered. The Statement indicates that the auditor should obtain an understanding of the nature of the act, the circumstances in which it occurred, and sufficient other information to evaluate the effect on the financial statements. If information provided by management is insufficient to determine whether an illegal act has occurred, the auditor should:

- Consult with the client's attorneys or other specialists about the application of laws and regulations relevant to the circumstances, and the possible effects on the financial statements.

- Apply additional procedures, if necessary, to obtain further understanding of the nature of the act.

2.325 If the auditor concludes that an illegal act has occurred, he or she must consider the implications (both qualitative and quantitative) of the illegal act on the auditor's report and the financial statements. Improper accounting or inadequate disclosure of a material illegal act could result in a qualified or adverse opinion, disclosing all substantive reasons for the opinion. If unable to obtain sufficient competent evidential matter about a possible illegal act, the auditor would generally disclaim an opinion on the financial statements. If the client refuses to accept a modified auditor's report in these situations, the auditor should consider withdrawing from the engagement, and should communicate the reasons for withdrawal to the audit committee or its equivalent, or to the board of directors or owners.

Make Preliminary Judgment About Materiality Levels

2.326 **Overall Materiality.** The auditor is required to plan an audit to provide reasonable assurance that material misstatements will be detected. Therefore, overall materiality for an engagement reflects the maximum dollar amount of misstatements the auditor is willing to accept in the financial statements as a whole without affecting the opinion. Specifically, SAS No. 47 (AU 312) defines materiality as "the magnitude of omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement."

2.327 The concept of materiality involves both qualitative and quantitative judgments and does not depend solely on the dollar amount. When misstatements are found, the auditor considers both of these factors in deciding whether the misstatement must be corrected or disclosed. However, for planning purposes, the auditor can only consider the quantitative aspect of materiality.

2.328 In planning the audit, SAS No. 22 requires the auditor to make preliminary judgments about materiality levels for the audit. Materiality levels include an overall level for each financial statement. However, for the purpose of planning audit procedures, the auditor generally uses the *smallest* amount that would be material to any one of the financial statements. This is because a misstatement of one financial statement often causes an equal misstatement of the related financial statements. Thus, if the auditor's preliminary judgment is that an aggregate misstatement of $50,000 would materially affect the statement of financial position, and it would take misstatements aggregating $100,000 to materially affect the income statement, the auditor would select the smallest amount, $50,000, as planning materiality. While there is no requirement to do so, many auditors find it useful to quantify the level of materiality for the audit.

2.329 Quantifying Materiality. The is no authoritative guidance for computing the level of overall materiality. Materiality for planning purposes in the audit of an entity is typically determined based on a percentage of a financial statement base. Often, the materiality base is the greater of total assets of the entity or of total revenues. The percentage used is a sliding scale based on the size of the entity, as illustrated below:

Materiality Base — Greater of Total Assets or Total Revenues		Percentage of the Base
Over	But Not Over	
$ 0	$ 30,000	6.00%
30,000	100,000	$ 1,800+ 5.00% in excess of $ 30,000
100,000	300,000	$ 5,300+ 3.00% in excess of $ 100,000
300,000	1,000,000	$ 11,300+ 2.00% in excess of $ 300,000
1,000,000	3,000,000	$ 25,300+ 1.50% in excess of $ 1,000,000
3,000,000	10,000,000	$ 55,300+ 1.00% in excess of $ 3,000,000
10,000,000	30,000,000	$125,300+ 0.50% in excess of $ 10,000,000
30,000,000	100,000,000	$225,300+ 0.25% in excess of $ 30,000,000
100,000,000	300,000,000	$400,300+ 0.20% in excess of $100,000,000
300,000,000	---	$800,300+ 0.15% in excess of $300,000,000

2.330 As an illustration of the application of the table,[1] assume that the entity has total assets of $80,000 and total revenues of $150,000. Using the larger materiality for planning purposes would be calculated as follows:

$5,300 + [(150,000-100,000) x 3.0%] = $6,800

2.331 Because many audits are begun prior to year end, it is often necessary to estimate the financial statement bases (total assets and total revenue) for use in calculating planning materiality. Usually these estimates are made based on the entity's year-to-date results, and considering any audit adjustments that are likely to be made. Audit adjustments from the prior period are often good predictors of the adjustments that will be necessary in the current year.

2.332 Using the Materiality Computation Form. A Materiality Computation Form is in Chapter 10, section 10.301. This form should be used to compute the overall materiality limit, the basic allowance for unknown misstatements to be used in substantive tests of balances sampling, and the lower limit for individually significant items. The lower limit for individually significant items can be used to determine immaterial sampling populations and account balances for which no auditing procedures are necessary.

[1] Subscribers to the 1994 edition of this Manual will notice that changes have been made to this table. These changes were made to better reflect the amounts and percentages used in current practice, and will result in lower materiality thresholds.

Staff the Engagement and Plan for Supervision

2.333 As part of the planning process, the auditor must provide reasonable assurance that persons who work on the audit possess the appropriate technical training and proficiency. SQCS No. 1 states the basic quality control requirement for assigning personnel to engagements:

> Policies and procedures for assigning personnel to engagements should be established to provide the firm with reasonable assurance that work will be performed by persons having the degree of technical training and proficiency required in the circumstances. In making assignments, the nature and extent of supervision to be provided should be taken into account. Generally, the more able and experienced the personnel assigned to a particular engagement, the less is the need for direct supervision.

2.334 The following should be considered in making assignments of individuals to audit engagements:

- Staffing and timing requirements of the specific engagement.
- Evaluation of qualifications of personnel regarding experience, position, background, and special expertise.
- The planned supervision and involvement by supervisory personnel.
- Projected time availability of individuals to be assigned.
- Situations where independence problems and conflicts of interest may exist or may appear to exist, such as assignment of personnel to engagements for clients who are former employers or are employers of certain kin.
- Continuity of personnel to provide an efficient audit, balanced against rotation of staff to provide other personnel with different experience.

2.335 Supervising personnel on an engagement is an ongoing process. However, at the initial planning stage of the engagement, supervision of personnel requires developing realistic estimates of the time that will be needed to perform and review the staff's work. Use of budgeting and time control documents facilitate effective engagement supervision and management. Although not required by professional standards, budget and time control analyses can help improve engagement profitability by identifying problems and inefficiencies early. Staff time should be recorded weekly on the Time Accumulation Sheet (Chapter 11, section 11.201), with total engagement time summarized on the Time Summary Form (section 11.200) and compared to budget. These documents have been designed for use in all audit engagements in excess of forty hours. Used consistently, they will make staff more conscious of the efficient use of time, cause staff to become more creative in performing engagements, create opportunities for communicating problems to engagement personnel, and contribute to increased engagement and firm profitability.

2.336 For budgets to benefit the firm and engagement personnel, they must first be realistically prepared. Budgets must be based on engagement circumstances, not on fees. All time spent on engagements must be charged to the client and entered on the Time Accumulation Sheet. At the completion of the engagement, the Time Accumulation Sheet should be reconciled to the firm's client Time Summary Form and to the firm's billing records. For engagements extending beyond one week of field work, the time should be accumulated and recorded on the Time Summary Form. If the staff becomes aware of ways to reduce audit time in the future, the suggestions should be noted on the Summary of Time Savings for Next Year Form (section 11.202).

Decide on the Most Cost-Beneficial Audit Approach

2.337 Two audit approaches are presented in this Manual: the ABC System and the All-Substantive Approach. The ABC System should be used if the entity has a good accounting system, and strong internal control structure policies and procedures. This system allows the auditor to assess control risk at below the maximum for each transition cycle, and to design an audit strategy that achieves the appropriate mix of tests of controls, analytical procedures, and substantive tests of balances. It also provides for testing at interim dates.

2.338 Under the ABC System, completion of the following documents helps the auditor develop a cost-beneficial audit approach:

- The Client Acceptance and Continuance Form and the Planning Memorandum, which require the auditor to inquire about situations that could affect the audit approach.
- The Internal Controls Questionnaire, which provides an understanding of the organization's control structure and a preliminary decision about the assessed level of control risk.
- The Risk of Potential Misstatements Evaluation Form, which is used to assess the risk that errors and irregularities could occur.
- The Planning Matrix, which combines the findings from the above forms and results in an audit strategy (that is, nature, timing, and extent of tests) for each major audit area.

The ABC System should be used on engagements in which the auditor plans to rely on the client's internal control structure in order to minimize substantive tests.

2.339 The All-Substantive Approach should be used on engagements for which a substantive approach is the most cost-beneficial. Under this approach, control risk is assessed at the maximum (or slightly below the maximum) and no or few tests of controls are performed. Therefore, this approach requires that all testing be done as of the balance-sheet date.

2.340 Completion of the following forms will help the auditor plan the most cost-beneficial approach under the All-Substantive Approach:

- The Client Acceptance and Continuance Form and the Planning Memorandum, which require the auditor to obtain information about situations that could affect the audit approach.
- The All-Substantive Approach Questionnaire, which provides an understanding of the entity's control structure and an evaluation of the risk of potential misstatements.

Perform Analytical Procedures

2.341 SAS No. 56, *Analytical Procedures* (AU 329), requires that analytical procedures be used for the following three purposes:

- In the planning stage, to plan the nature, timing, and extent of other auditing procedures.
- As a substantive test to obtain evidential matter about financial statement assertions.
- In the final review stage, as an overall review of the financial information.

2.342 The purpose of analytical procedures performed during the planning stage of an audit is to identify unusual transactions or events and any areas that represent specific risks, so that the auditor can plan an appropriate audit strategy, i.e., the appropriate nature, timing, and extent of tests.

2.343 Analytical procedures used in planning the audit should focus on enhancing the auditor's understanding of the client's operations, transactions, and events that have occurred since the last audit, and on identifying areas that may present significant audit risks. Such procedures range from reviewing changes from the prior year to the current year's working trial balances, to more extensive analyses using quarterly financial information.

2.344 The Audit Planning Memorandum (Chapter 10, section 10.300) contains a requirement for performing analytical procedures in the planning stage of the audit. Substantive analytical procedures are included in the Tests of Balances Audit Program (Chapter 10, section 10.700). Analytical procedures performed at the final review stage are discussed in Chapter 7.

Change in 1995 Edition of the Tests of Balances Programs and the Analytical Procedures Program

Based on feedback we have received from users of this Manual, we have revised the 1995 edition of the Tests of Balances Programs. Each Tests of Balances Program now includes the related substantive analytical procedures (previously included in the Analytical Procedures Program), which is designed to allow you to more easily choose the right mix of tests of details and substantive analytical procedures for each major audit area, based on the results of completing the Internal Controls Questionnaire, the Risk of Potential Misstatements Form, and the Tests of Controls Program, and considering which types of tests are the most efficient and effective for the audit area. Because of this change, the separate Analytical Procedures Program is no longer included in this Manual.

2.400 DOCUMENTING AUDIT PLANNING DECISIONS

2.401 The Audit Planning Memorandum in Chapter 10, section 10.300 is the culmination of the planning process and should be prepared for all audit engagements. It is critical to achieving both engagement quality and profitability. The Memorandum should be prepared by engagement in-charge and approved by the engagement partner before engagement personnel begin field work. It can be prepared using the form in section 10.300 or in a handwritten or typed narrative.

2.402 The Audit Planning Memorandum is comprised of Section I, Engagement Administration, and Section II, Technical Audit Planning Decisions. A few words about section subheadings follow:

I. A. Presentation of Engagement Letter

The engagement letter is a primary tool for obtaining client understanding of the firm's responsibilities and the client's. A good understanding before the engagement begins will prevent misunderstandings later. To gain a good understanding, the engagement partner should deliver the letter and discuss its contents with the entity's audit committee or persons of equivalent authority or with management.

I. B. Use of Client Assistance or Paraprofessionals

The schedule attached to the Client Acceptance and Continuance Form lists possible areas of client assistance. Client assistance should be used to the maximum extent possible on every engagement. When client personnel are unavailable, the use of firm paraprofessionals to perform any necessary accounting services and clerical work in connection with the engagement should be considered.

I. C. Planning for Proper Work Space and Equipment

The engagement in-charge has responsibility for arranging adequate work space before the field work begins. Poor lighting, lack of adequate heat or air conditioning, desks or tables that are too small, or work locations that are not near client accounting records and personnel are examples of situations that hinder the efficient completion of an engagement.

I. D. Assignment of Staff

A basic element of a good quality control system is assigning personnel to engagements and to tasks that are commensurate with their capabilities. Assigning the right people to engagements also helps complete the engagements in the minimum amount of time.

Whenever possible, the prior year's engagement personnel should be reassigned and rotated to new positions each year. When reassignment is not possible, an attempt should be made to assign new staff with experience in the client's industry. When inexperienced personnel, or personnel unfamiliar with the client's industry, are assigned to an engagement, the in-charge is responsible for providing appropriate training.

I. E. Target Dates

Setting target dates during planning is the first step to achieving timely engagement completion. These target dates should also become the input to the firm's staff scheduling system.

I. F. Use of Specialists

The firm should consider using outside specialists whenever audit procedures require knowledge or skills beyond the auditing firm's expertise. Such areas may include actuarial computations for pension funds, questions of law, or audits designed using clients' EDP systems.

I. G. Use of Audit Software

Audit software should be used to the maximum extent practical on all engagements. This section should list the specific, planned applications.

I. H. Audit Budget

The audit budget should be prepared, at least tentatively, prior to beginning field work. The budget should be based on circumstances, not on fees. The budget documents should be summarized in this section for discussion with the engagement partner.

I. I. Other Considerations:

This section is provided to document any significant engagement administration circumstances or problems not covered above.

II. A.-F. Technical Audit Planning Decisions

Each section should present the results of the decisions, as well as the rationale, or judgments, behind them. Detailed computations or explanations should be either included or incorporated by reference to other working papers or forms. Section II.E. must include documentation about the assessed level of control risk if the assessed level of control risk is below the maximum.

II. G. Planning Analytical Procedures

Analytical procedures used in planning the audit should focus on enhancing the auditor's understanding of the client's operations, transactions, and events that have occurred since the last audit, and on identifying areas that may present significant audit risks. Such procedures range from reviewing changes from the prior year to the current year's working trial balances, to more extensive analyses using quarterly financial information.

II. H. Other Considerations

Risks of misstatements, irregularities, or illegal acts, or any other accounting or auditing problems discovered during planning, should be discussed in this section. The situation, its possible impact on financial statements, and the planned modification of auditing procedures should be detailed for consideration and approval by the engagement partner.

2.500 FIRST-YEAR ENGAGEMENTS

Communications With Predecessor Accountants — Compilation, Review, and Audit Engagements

2.501 Whenever the auditor succeeds another auditor or accountant, he or she should obtain the client's permission to contact the client's previous auditor and discuss the client's reasons for changing, any disagreements with management about accounting principles or engagement procedures, the integrity of management or majority owners, and the availability of the predecessor's working papers for review. Similar communications with the predecessor accountants should be considered in compilation and review engagements.

> **Practice Tip:**
>
> Successor accountants in a compilation or review engagement who become aware of information that lead them to believe the financial statements reported on by the predecessor accountant may require revision, should request the client to communicate that information to the predecessor. If the client does not communicate that information to the predecessor, or if the successor is not satisfied with the predecessor's handling of the situation, the successor should consult with his or her attorney.

2.502 **Requests for Information.** A predecessor accountant should respond promptly to normal requests for information from successor accountants providing the former client has authorized the predecessor to disclose such information, and providing the client has agreed to pay for time and expenses. Inquiries made by the successor accountant ordinarily include specific questions concerning facts that might bear on the integrity of management; on disagreements with management as to accounting principles, auditing procedures, or similar matters; and on the predecessor's understanding as to reasons for the change of auditors.

2.503 **Working Papers.** In the event of proposed litigation or other unusual requests, the office managing partner should contact the firm's legal counsel before releasing any information. In normal circumstances, with the former client's permission, the accountant will make the working papers available for review by successor accountants after all client billings have been paid. Working papers should be reviewed under the accountant's control and copies made only of working papers of continuing significance. The Planning and Supervision File should *not* be copied.

Reissuance of Reports

2.504 A successor accountant will normally reissue reports on previous engagements for compilation, review, and auditing services when they are engaged for the current period, provided the predecessor:

1. Read the current-period financial statements.

2. Compared the prior-period financial statements with the current-period statements.

3. Obtained a letter of representation from the successor accountants stating that any information discovered during their engagement, affecting the previous period, has been made available to them. (See sample letter in section 13.023.)

4. Is satisfied that none of the above procedures caused the previous report to be inappropriate.

2.505 If information is subsequently discovered that makes the previous report inappropriate, the accountant should consider revising the report or financial statements, or declining reissue. In any event, the former client must consent to paying fees for any procedures performed by the accountant.

Practice Tip:

Although not required, a predecessor auditor is well advised to inquire about and consider the professional reputation and independence of the successor auditor before reissuing his or her report. In fact, the authors believe it is a good idea to obtain a representation from the successor auditor that he or she is independent under the requirements of the AICPA and, if appropriate, the requirements of the Securities and Exchange Commission. However, the predecessor auditor should not refer in his or her reissued report to the report or work of the successor auditor.

Relying on Work of Other Accountants

2.506 When other accountants are engaged to perform an audit or review of a division, branch, subsidiary, or other section of a client's financial statements, certain procedures are advised:

1. Determine the other accountants' independence in accordance with SAS No. 1, Section 543, paragraph 10. (AU 543.10)

2. Obtain a letter of representation of the other accountants' independence. An illustrative letter is included in Chapter 13, section 13.022.

3. Obtain an engagement letter from the other accountants.

2.507 These provisions do not apply to engagements of other accountants for limited procedures under the accountant's supervision, e.g., observation of inventories.

Documentation of Communications With Other Accountants

2.508 The engagement partner should prepare a memo documenting the nature of the communication, procedures performed, and the resulting action taken. The memo should be approved by the accounting and auditing partner and filed in the Planning and Supervision File.

Preparing a Proposal

2.509 Accountants are frequently requested to prepare engagement proposals for new or recurring engagements. A proposal letter is a sales document. It should be well organized and effectively written, and most of all, it should be based on a good understanding of the client's business and industry and the requirements of the engagement. At a minimum, the firm should complete the Client Acceptance and Continuance Form and the applicable checklists.

2.510 The forms could be completed, at least in part, by client personnel and reviewed by the in-charge. The in-charge should tour the client's facilities and observe personnel while reviewing the completed forms and checklists.

2.511 For proposals on repeat engagements, an understanding should be obtained from staff experienced with the client, from the working papers and other engagement files, and from discussions with client personnel.

2.512 Fee Estimation. Once a good understanding of the client's business and industry has been obtained, an estimate of the time to complete the engagement should be prepared by the in-charge. After obtaining copies of the prospective client's most current financial statements, general ledger trial balance, and an illustrative copy of the audit or engagement work program for guidance, budget estimates should be prepared. After allocating time among staff levels, billing rates per hour should be applied to obtain a total estimate of engagement fees. The firm's budget documents should be used for this purpose. The in-charge should review the results of the estimation process with the engagement partner.

2.513 Writing the Proposal Letter. The proposal letter should be organized logically. Use specific, understandable words and short sentences. Verbs should be written in the active voice. The letter should describe how the firm can meet the potential client's needs by discussing the following:

- The firm's quality control standards. Membership in the AICPA Division for CPA Firms, and the criteria for membership, or other quality control activities should be emphasized.
- The firm's experience with similar clients, or its expertise in the client's industry should be mentioned. Partner or staff industry affiliations should also be included.
- The basic services requested by the client, and other services that could be helpful to the client, should be identified.
- The firm's credits in terms of skill resources, client base, location of offices, and staff size should be included.
- The firm's contacts with bankers, advisors and industry, or business leaders in the community are important.
- With prior approval, reference to other clients that can attest to the firm's competence will help sell the engagement.
- Fees, or ranges, the basis of their determination and the client's responsibilities should be discussed.

2.514 Chapter 13, section 13.027 contains an illustrative proposal letter. Of course, it should be modified for each engagement's circumstances.

First Engagement Procedures

2.515 The objectives of the current level of service will determine the nature and extent of the first engagement procedures. The procedures performed applies to balances at the beginning as well as at the end of the year. The auditor should consider the beginning balances on audit engagements.

2.516 A First Engagements Procedures Form for audit engagements used to determine that beginning balances are presented fairly and that GAAP has been consistently applied is included in section 10.303.

The ABC Approach

CHAPTER 3

THE AUDIT APPROACH: THE ABC SYSTEM OR THE ALL-SUBSTANTIVE APPROACH

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CHAPTER 3

THE AUDIT APPROACH: THE ABC SYSTEM OR THE ALL-SUBSTANTIVE APPROACH

3.000 INTRODUCTION

3.001 This chapter presents a unique approach to audit planning and performance—an approach designed specifically to minimize substantive testing and thereby maximize engagement profits. This Manual provides all the forms, questionnaires, programs, and workpapers needed to meet planning and documentation requirements, as well as to determine the most cost effective way to conduct an engagement.

3.002 Also included in this chapter is sampling guidance for the basic financial statement audit.

3.100 OVERVIEW OF AUDIT APPROACHES

Overview of ABC System

3.101 The ABC System is a unique approach to planning and performing an audit, in that it is designed to allow the auditor to assess the control risk for each of the major audit areas of an entity, and to provide the auditor with the tests of controls, tests of balances, and analytical procedures most likely to be relevant to each major audit area.

3.102 The ABC System is based on the assumption that the auditor will determine that it is more efficient to perform tests of controls for some or all major audit areas in order to reduce substantive testing while maintaining high audit quality and complying fully with all generally accepted auditing standards.

3.103 The ABC System's Internal Controls Questionnaire (Chapter 10, section 10.100) is organized into three levels of priorities (for each major audit area):

- those controls necessary to provide the client with an effective basic accounting system (level C),
- those controls necessary to provide the client with both an effective accounting system and good primary controls (levels B and C acting together), and
- those controls necessary to provide the client with good secondary controls, as well as good primary controls and an effective accounting system (levels A, B, and C acting together).

3.104 By completing the entire Internal Controls Questionnaire for an audit engagement, the auditor can assess the controls for each major audit area. The auditor can then exercise judgment to determine that:

- a major audit area for which all (or substantially all) controls in the A, B, and C levels are present would qualify as an "A System," for which the auditor could assess control risk as low or moderate (which would justify minimizing substantive tests once the controls themselves are tested),
- a major audit area for which all (or substantially all) controls in the B and C (but not the A) levels are present would qualify as a "B System," for which the auditor could assess control risk as moderate to slightly below the maximum (which would justify reducing some substantive tests once the controls are tested), or
- a major audit area for which all (or substantially all) controls in the C level (but not the A and B levels) are present would qualify as a "C System," for which the auditor could assess control risk as maximum to slightly below maximum (which would cause the auditor to perform primarily substantive tests in most cases, even after the controls are tested).

3.105 Illustration No. 3-1 portrays the interrelationship of control risk and degree of reliance on controls for systems classified as A, B, or C.

3.106 The Manual's programs for tests of controls (Chapter 10, section 10.400) and tests of balances (section 10.700) are organized according to whether controls over a major audit area are determined to constitute an A System, a B System, or a C System. Each major audit area must be assessed and classified independently from other major audit areas; thus, the payroll cycle may be classified as an A System, the payments and acquisitions cycle may be classified as a B System, and the sales and revenue cycle as a C System. Of course, an auditor must use his or her understanding of the client and the client's industry to customize the precise audit program for an engagement, but the ABC System helps the auditor determine appropriate and justifiable levels of substantive testing without "overauditing" or "underauditing."

3.107 The ABC System incorporates analytical procedures to the maximum extent possible, whether a system is rated as A, B, or C, in order to obtain the optimal mix of audit evidence for quality and efficiency. The ABC System is discussed further in section 3.300.

Overview of All-Substantive Approach

3.108 **The Approach.** This Manual's All-Substantive Approach presumes that the auditor obtains an understanding of the internal control structure sufficient to plan the audit (see section 2.306) and assesses control risk at the maximum. The approach assumes controls will not be tested and that analytical procedures and substantive tests will be used extensively.

3.109 There are two ways in which an auditor may come to the decision to assess control risk at the maximum for all major audit areas: elective and forced.

3.110 **Elective Use of the Approach.** If the client's operations and financial statements are noncomplex, an auditor may decide that substantive testing can easily provide all the evidential matter needed for him or her to express an opinion on the financial statements.

ILLUSTRATION NO. 3-1

RELIANCE MATRIX

Reliance on Types of Tests Based on Control Risk Assessment

Audit Approach	Control Risk	Tests of Controls	Analytical Procedures	Tests of Balances
ABC System:				
System A: Good Internal Control Procedures	Low to Moderate	High Reliance	Maximum Extent Possible	Low Reliance
System B: Good Accounting System and Primary Controls	Moderate to Slightly Below the Maximum	Moderate Reliance	Maximum Extent Possible	Medium Reliance
System C: Good Accounting System or More Efficient Tests of Balances Approach	Slightly Below the Maximum to Maximum	Low or No Reliance	Maximum Extent Possible	Slightly less than High to High Reliance
All-Substantive Approach				
Weak Accounting System or More Efficient Test of Balances Approach (System C Tests Of Controls)	Slightly Below the Maximum to Maximum	Low or No Reliance	Maximum Extent Possible	Slightly less than High to High Reliance

3.111 For this type of client, the auditor may decide to "artificially" assess control risk at the maximum for all major audit areas to avoid the inefficient use of audit time, to test the internal control structure, and to perform an All-Substantive audit.

3.112 This Manual provides an All-Substantive Approach Questionnaire (section 10.200) for the auditor to document his or her understanding of the client's internal control structure. By using this Questionnaire, an auditor may bypass the two ABC System steps of completing the Internal Control Questionnaire and performing extensive tests of controls. However, performing limited tests of controls is recommended to enhance the auditor's understanding of the internal control structure and the flow of transactions through the accounting system. Completing some or all of the System C Test of Controls Programs can satisfy these objectives.

3.113 **Forced Use of the Approach.** The auditor does consider controls over each major audit area and determines that control risk in fact should be assessed at maximum, due to absent or faulty controls or due to inadequate compliance with the controls that ostensibly are in place. Such situations would call for the forced use of the All-Substantive Approach, unless or until the auditor determines that the client records are not auditable, which would require a scope limitation or withdrawal from the engagement.

3.114 The All-Substantive Approach is discussed further in section 3.400.

3.200 TYPES OF TESTS

3.201 In developing an audit strategy, the auditor must consider, among other things, the relative efficiency and effectiveness of the three types of audit procedures—tests of controls, tests of balances, and analytical procedures. To help in this determination (which influences the auditor's selection of the ABC System or the All-Substantive Approach), the following sections briefly describe these three types of tests.

Tests of Controls

3.202 When the auditor assesses control risk at below the maximum (such as for a System A or B), he or she must perform tests of controls to support the lower assessed level of control risk. Appendix B of SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU 319.67), defines tests of controls as:

> Tests directed toward the design or operation of an internal control structure policy or procedure to assess its effectiveness in preventing or detecting material misstatements in a financial statement assertion.

3.203 Examples of tests of controls include inquiries of client personnel, inspection of documents and reports, and observation of the application of a control policy or procedure. Performing tests of controls to support a lower assessed level of control risk allows the auditor to reduce substantive tests. As a result, before performing tests of controls, the auditor should weigh the relative effort needed to perform the tests of controls against the effort saved by reducing substantive tests. Tests of Controls Programs are included in Chapter 10, section 10.400.

Substantive Tests

3.204 Paragraph 4.11 of the AICPA's Audit Guide, *Consideration of the Internal Control Structure in a Financial Statement Audit*, states:

> The auditor makes judgments about the nature of substantive tests based on an assessment of the effectiveness and efficiency of the available alternative procedures in detecting material misstatements. The procedures may include substantive analytical procedures, substantive tests of details, or a combination of both. Judgments about the nature, timing, and extent of audit procedures are influenced by the —
>
> - Assessment of the inherent risk of material misstatement.
> - Materiality of transactions and balances.
> - Assessed level of control risk.
> - Amount, volume, and variability of transactions and balances.
> - The effectiveness of other available audit procedures.

3.205 As a result, the assurance an auditor needs from substantive tests (which is based on the assessed level of control risk and tests of controls) is obtained by performing substantive tests of balances procedures, substantive analytical procedures, or a combination of both.

3.206 Depending on the nature and extent of the analytical procedures, it may be possible to *substantially* reduce the related substantive tests of balances. For example, a reasonableness test of depreciation expense may eliminate detail tests of a client's depreciation schedule. As another example, calculation of units sold times average sales price to predict sales revenues may eliminate the need for further analysis of that account. In both of these cases, a simple analytical procedure can be used to adequately verify all the financial statement assertions for a general ledger account balance. Further tests of those balances may not be necessary.

3.207 **Substantive Tests of Balances.** Whenever control risk is assessed at the maximum level, the auditor will perform extensive substantive tests. Characteristics of highly reliable substantive tests are that they are performed at year end rather than at interim dates, the evidence provided by the tests is highly reliable (such as examining supporting documents prepared by a third party rather than internally-prepared documents), and larger sample sizes are selected.

3.208 When the auditor performs tests of controls, the nature, timing, and extent of substantive tests may be changed. The Evidence Matrix in Illustration No. 3-2 shows the impact of a client's internal control structure on the substantive tests of balances evidence.

3.209 The Tests of Balances Audit Program is included in Chapter 10, section 10.700.

3.210 **Analytical Procedures.** Analytical procedures can provide evidence supporting financial statement assertions and, thus, can be used as substantive tests. Analytical procedures are often the least expensive tests. Accordingly, they should be used whenever practical.

3.211 SAS No. 56, *Analytical Procedures* (AU 329), describes analytical procedures as follows:

> Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations:
>
> a. Financial information for comparable prior period(s) giving consideration to known changes.
>
> b. Anticipated results—for example, budgets or forecasts including extrapolations from interim or annual data.
>
> c. Relationships among elements of financial information within the period.
>
> d. Information regarding the industry in which the client operates—for example, gross margin information.
>
> e. Relationships of the financial information with relevant nonfinancial information.

3.212 Whenever analytical procedures are applied as substantive tests, the auditor must apply the following procedures:

1. Consider whether the relationship is plausible and predictable.
2. Consider whether the data used for the comparison is reliable.
3. Consider whether the account balance tested is consistent with the auditor's expectations. If it is not consistent, obtain the client's explanation for the variance and get evidence to corroborate the client's explanation.

3.213 The Tests of Balances Audit Program (Chapter 10, section 10.700) contains recommended analytical procedures. But be alert for additional opportunities to apply these procedures whenever they are effective and practical.

Change in 1995 Edition of the Tests of Balances Programs and the Analytical Procedures Program

Based on feedback we have received from users of this Manual, we have revised the 1995 edition of the Tests of Balances Programs. Each Tests of Balances Program now includes the related substantive analytical procedures (previously included in the Analytical Procedures Program), which is designed to allow you to more easily choose the right mix of tests of details and substantive analytical procedures for each major audit area, based on the results of completing the Internal Controls Questionnaire, the Risk of Potential Misstatements Form, and the Tests of Controls Program, and considering which types of tests are the most efficient and effective for the audit area. Because of this change, the separate Analytical Procedures Program is no longer included in this Manual.

ILLUSTRATION NO. 3-2

EVIDENCE MATRIX

Audit Approach	Control Risk for Most Financial Statement Assertions	Substantive Tests of Balances Evidence: Amount	Nature	Extent	Timing
ABC Approach					
System A: Good Internal Control Procedures	Low	Small Amounts	Least Reliable	Small Samples	Most Precede Year End
System B: Good Accounting System and Primary Controls	Moderate	Medium Amounts	More Reliable	Medium Samples	Some Precede Year End
System C: Good Accounting System	Slightly Below the Maximum to Maximum	Large Amounts	Most Reliable	Large Samples	Most at Year End
All-Substantive Approach					
Weak Accounting System or More Efficient Tests Of Balances	Slightly Below the Maximum to Maximum	Large Amounts	Most Reliable	Large Samples	Most at Year End

3.300 THE ABC SYSTEM

3.301 As mentioned in section 3.102, the ABC System should be used for engagements in which the auditor will perform tests of controls in order to minimize substantive tests. The following are the basic steps involved in designing an audit approach using the ABC System, and the forms and documents contained in this Manual related to those steps:

Procedure	Documentation
1. Understand the entity's operations and industry.	1. Client Acceptance and Continuance Form
2. Perform audit planning procedures.	2. Audit Planning Memorandum
3. Perform analytical procedures sufficient to plan the audit.	3. Audit Planning Memorandum
4. Obtain an understanding of the entity's internal control structure.	4. Internal Controls Questionnaire and Initial Survey of EDP Controls
5. Assess the risk that misstatements in the financial statements could occur.	5. Risk of Potential Misstatements Evaluation Form
6. Assess control risk for each financial statement assertion and determine the tests of controls and the level of substantive tests to be performed.	6. Internal Controls Questionnaire and Planning Matrix

3.302 Procedures 1, 2, and 3 are discussed in Chapter 2 of this Manual. The following sections discuss procedures 4, 5, and 6 and the related documentation.

Internal Control Structure

3.303 SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU 319), requires the auditor to obtain a sufficient understanding of an entity's control structure (control environment, control policies and procedures, and accounting system) to adequately plan the audit and to determine the nature, timing, and extent of audit procedures. The description of the three elements of the control structure contained in SAS No. 55 is shown in Illustration No. 3-3.

ILLUSTRATION NO. 3-3

ELEMENTS OF THE INTERNAL CONTROL STRUCTURE

For a financial statement audit, an entity's internal control structure comprises the following:

Control Environment: The collective effect of various factors on establishing, enhancing, or mitigating the effectiveness of specific policies or procedures. The control environment includes such factors as—

- Management's philosophy and operating style.
- The entity's organizational structure.
- The functioning of the board of directors and its committees, particularly the audit committee.
- Methods of assigning authority and responsibility.
- Management's control methods for monitoring and following up on performance, including internal auditing.
- Personnel policies and practices.
- Various external influences that affect an entity's operations and practices, such as examinations by bank regulatory agencies.

The control environment reflects the overall attitude, awareness, and action of the board of directors, management, owners, and others concerning the importance of control and its emphasis in the entity.

Accounting System: The methods and records established to identify, assemble, analyze, classify, record, and report an entity's transactions and to maintain accountability for the related assets and liabilities. An effective accounting system will give appropriate consideration to establishing methods and records that will—

- Identify and record all valid transactions.
- Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Present properly the transactions and related disclosures in the financial statements.

(continued)

ILLUSTRATION NO. 3-3 (Continued)

ELEMENTS OF THE INTERNAL CONTROL STRUCTURE

Control Procedures: Those policies and procedures, in addition to the control environment and the accounting system, that management has established to provide reasonable assurance that specific entity objectives will be achieved. Control procedures pertain to—

- Proper authorization of transactions and activities.
- Segregation of duties to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of his or her duties—assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets.
- Design and use of adequate documents and records to help ensure proper recording of transactions and events, such as monitoring the use of prenumbered shipping documents.
- Adequate safeguards over access to and use of assets and records, such as secured facilities and authorization for access to computer programs and data files.
- Independent checks on performance and proper valuation of recorded amounts, such as clerical checks, reconciliations, comparisons of assets with recorded accountability, computer-programmed controls, management review of reports that summarize the detail of account balances (for example, an aged trial balance of accounts receivable), and user review of computer-generated reports.

3.304 Completion of the Internal Controls Questionnaire (section 10.100) satisfies the SAS No. 55 requirement to obtain and document the understanding of the three elements of the control structure. Additional narratives and flowcharts may be useful on larger, more complex engagements, however, they should supplement rather than replace the Internal Controls Questionnaire.

3.305 The Questionnaire contains the following six sections, representing 10 major audit areas for a typical commercial entity:

I. Cash
II. Accounts receivable confirmations and alternative procedures and sales cutoff.
III. Vouching and inspecting fixed assets, search for unrecorded liabilities, purchases cutoff, and expense account analysis.
IV. Payroll tests.
V. Physical inventory observation and pricing and clerical tests.
VI. All cycles.

3.306 The Internal Controls Questionnaire, Tests of Controls Programs, and Tests of Balances Programs are designed to cover the major audit areas for a typical commercial entity and are based on transaction cycles. Strengths and weaknesses in the internal control structure for each transaction cycle must, therefore, be reflected in the auditor's planned assessed level of control risk. The relationship is illustrated in Illustration No. 3-4, "Relationship of Major Audit Areas to Transaction Cycles."

ILLUSTRATION NO. 3-4

RELATIONSHIP OF MAJOR AUDIT AREAS TO TRANSACTION CYCLES

Major Audit Area	Related Transaction Cycles
1. Cash	1. Collections and payments.
2. Accounts receivable confirmation and alternative procedures	2. Sales and collections.
3. Sales cutoff	3. Sales and collections.
4. Physical inventory observation	4. Inventory and warehousing.
5. Tests of balances inventory pricing and clerical tests	5. Inventory and warehousing.
6. Vouching and inspecting fixed assets	6. Acquisitions and payments.
7. Search for unrecorded liabilities	7. Acquisitions and payments.
8. Purchases cutoff	8. Acquisitions and payments.
9. Payroll tests	9. Payroll and personnel.
10. Expense account analysis and vouching	10. Acquisitions and payments.

3.307 Within each of the six sections of the Internal Controls Questionnaire listed in section 3.305 are three categories of controls: the accounting system controls, primary controls, and secondary controls. As described below, the "yes" and "no" responses within the three categories will help the auditor select the proper system for that section. System C is the weakest system and is characterized by good accounting system controls, but weak primary and secondary controls; System A is the strongest and is characterized by good accounting system and good primary and secondary controls. Even if the auditor anticipates that some major audit areas will be C Systems, all questions should be answered so that the auditor's requirement to understand the control structure is met. The following describes how to select the appropriate system (A, B, or C) after completing the Internal Controls Questionnaire.

1. Within each of the six sections of the Questionnaire, identify the most advanced system classification, A, B or C, with a majority of "yes" answers in each section of the Questionnaire. Because tests of controls often require less time than tests of balances, the objective should be to perform tests of controls to the maximum extent practical.

2. Consult with the engagement partner to determine if tests of controls for the system classification selected are practical in light of past experience with the client. Prior years' unacceptable results from tests of controls, and the resulting high reliance on tests of balances, may cause the executive to select a lower system classification, i.e., B or C, and minimize controls testing. In other words, this decision may prevent overauditing.

3. For all "no" answers, i.e., potential weaknesses, up to and including the system selected in each section, complete the following process:

   a. Determine if the "no" answer is, in fact, a weakness.

   b. For the potential weakness, review any "yes" answers to other controls for possible offsetting strengths. Such strengths could be included within the system classification selected or in a more advanced system. For example, a weakness in a System B (a "no" answer) could be offset by another control within System B (a "yes" answer) or by a control in System A.

   c. The Tests of Controls Programs have been designed to test the controls that exist in each system, as evidenced by the Internal Controls Questionnaire. For example, the control in a System A that may offset a weakness in System B would not be tested when the System B Tests of Controls program is used. To rely on the offsetting System A control, a modifying test of that control must be added to the System B program.

   d. Select the Tests of Controls Programs for each section of the Questionnaire that corresponds with the selected system classification, A, B, or C.

3.308 The in-charge's selection of the type of internal control system should be recorded on the Planning Matrix (section 10.103), and reviewed by the engagement partner before the in-charge selects the corresponding Tests of Controls Programs.

3.309 An Internal Controls Questionnaire is included in section 10.100.

Internal Controls Over Computer Processing

3.310 SAS No. 55 requires the auditor to obtain an understanding of an entity's internal control structure, including the controls over computer processing. This understanding of computer processing controls, which is required even when an all substantive approach to the audit is taken, enables the auditor to design effective substantive tests. This section describes how the auditor can obtain this required understanding, and how it may be documented in the working papers. It also describes typical tests of computer processing controls.

Change in 1995 Edition of the Internal Controls Over Computer Processing

The Guidance and documentation for computer processing and service organization controls (previously in Chapter 2) have been revised to enhance efficiency and to better reflect today's computer environment. Accordingly, the following forms appearing in the prior edition of this Manual have been deleted and replaced with new forms: (1) Small Business Microcomputer Installation Survey Form, (2) Initial Survey of EDP Controls—General Controls, (3) Initial Survey of EDP Controls—In-House System, and (4) Initial Survey of EDP Controls—Service Center-Produced Records Parts I and II.

3.311 Today's computer environment is very diverse. Many entities use microcomputer systems to maintain all of their accounting records. Larger entities use mainframe computers that are often linked to microcomputer work stations. This section may be used to evaluate the computer controls for clients that have a sophisticated computer system, as well as those that use microcomputers and purchased software products.

3.312 Sections 3.313 through 3.315 explain the various types of computer controls that may be established by a client. Tests of computer controls are addressed in sections 3.324 through 3.332. Sections 3.333 through 3.343 describe the auditor's consideration of computer controls when a client has a significant accounting application that is processed by a service organization (e.g., a data processing service center, mortgage servicer, or benefit plan servicer). The following elements of documentation assistance are included in this section:

- The Microcomputer Questionnaire (section 10.601) is designed to document the required understanding of computer processing controls in audit engagements in which the client's computer system is comprised of only microcomputers and purchased software products. If the computer system has some of the controls included in the Questionnaire, the procedures used to obtain an understanding of the computer processing controls will usually provide evidence that will support a lower assessed level of control risk.

- The General Computer Controls Questionnaire and the Application Computer Controls Questionnaire (sections 10.602 and 10.603)—designed to document the auditor's understanding of computer systems that are more sophisticated (e.g., when the client develops its own software).

- Service Organization Application Controls Questionnaire (sections 10.651)—designed to document the auditor's understanding of the controls at a service organization when it is necessary to obtain and understand those controls and a service auditor's report is not available.

- The Service Auditor Report Evaluation Form (section 10.652)—designed to document the auditor's evaluation of the report of a service auditor when it is necessary to obtain an understanding of the controls applied at a service organization.

3.313 **Computer Systems Controls.** To evaluate a client's internal control structure, the auditor should have a general understanding of the different computer system controls. In this section the two major types of computer controls—general controls and application controls—are briefly described.

3.314 General controls affect all applications and include:

a. Adequate segregation of computer-related duties, e.g., computer operation, programming, and data input,
b. Controls over the development and testing of programs and systems,
c. Procedures to prevent unauthorized changes to existing programs and systems,
d. Controls over access to programs and data, and
e. Controls over computer operations.

3.315 Application computer controls are those that relate only to a specific accounting application, such as payroll. Application controls include those that relate to input, processing, and output of specific information. For example, application controls for payroll would include:

- Controls to ensure the accuracy of the input of hours and wage rates, such as reviews of credit reports.
- Controls over the accuracy of payroll checks and reports, such as reconciliation of control totals, or supervisory review of checks and reports.

Practice Tip:

General controls affect all computer applications. If a client has weak general controls, the auditor generally cannot place any reliance on application controls.

3.316 **Obtaining an Understanding of Computer System Controls.** As a part of planning the audit, the auditor should identify those account balances, transaction classes, and disclosure components of the financial statements that involve significant computer processing. This will define the scope of the auditor's review of computer system controls. If the systems are very complex, it may be useful to prepare flowcharts documenting significant computer applications. The information in these flowcharts may be obtained from prior knowledge of the client's business, discussions with client personnel, and reference to prior year's workpapers.

Practice Tip:

Flowcharts generally should be prepared only when the computer system is very complex and the auditor is planning to assess control risk at a moderate or low level.

3.317 **Procedures to Obtain Understanding.** The auditor obtains an understanding of computer-related controls through procedures such as inquiry, observation, and inspection of documents. For example, to obtain an understanding of the design of the computer system used to generate the general ledger, the auditor may make inquiries of appropriate personnel about input, processing, and output control procedures, and inspect application software documentation. The auditor may inquire about data security and database backup procedures, and inspect any control reports or logs. The auditor also may observe users of the system in actual performance of their duties and review the resultant documents and records.

3.318 The nature and extent of the auditor's understanding will vary from client to client, and is influenced by the size and complexity of the client's computer system and procedures. The auditor's prior experience with the client and assessments of inherent risk and materiality of the various account balances and transaction classes may also effect the nature and extent of the audit procedures performed to obtain an understanding of the computer controls.

3.319 Documenting Computer System Controls. The Microcomputer Questionnaire (section 10.601) may be used to document the client's controls when the computer system consists of microcomputers and purchased software products. This is the only computer questionnaire that should be completed for such clients.

3.320 For clients with more sophisticated computer systems, the auditor may complete:

- The General Computer Controls Questionnaire (section 10.602)
- The Application Computer Controls Questionnaire (section 10.603)

3.321 The General Computer Controls Questionnaire documents controls over the client's computer system environment. The areas addressed include data processing management issues, systems development practices, and policies regarding end-user developed systems. If the client does not develop any application software internally, many of the questions in this questionnaire will not apply.

3.322 The Application Computer Controls Questionnaire is used to document the nature of each major computer application. The information prepared to document the understanding of the internal control structure elements will vary depending on the size and complexity of the client and its computer systems.

3.323 In some cases, the auditor may find it necessary to prepare additional materials to adequately document complex applications. Block diagrams, flowcharts, database structure listings, video display layouts (screen shots), and narratives are sometimes used to document the flow of transactions through a complex system. Copies of key input forms, computer prepared documents, and reports also may help to describe the nature of the computer processing. For very complex computer systems, the auditor should consider getting a computer specialist to participate in the review.

3.324 Tests of Controls for Microcomputer Systems. In addition to obtaining an understanding of the internal control structure, the auditor may perform tests of controls. These tests provide evidential matter to support an assessed level of control risk below the maximum. Tests of controls may be directed toward the effectiveness of the design of internal control structure policies and procedures, or they may be directed toward the effectiveness of operation of the policies and procedures during the period under audit.

3.325 Test of controls in a microcomputer environment are not significantly different from those in a manual accounting environment. Control over a microcomputer can be achieved in one of two ways:

- Adequate segregation of duties exists, and access to the computer system is controlled to prevent changes in programs and data by unauthorized employees, or
- Adequate segregation of duties does not exist or access to the computer system is not adequately controlled, but these weaknesses are mitigated by the fact that appropriate personnel (e.g., the owner/manager) perform a detailed review of the computer reports.

3.326 These controls can generally be tested with observation, inquiry, and inspection of computer reports. The Microcomputer Questionnaire (section 10.601) may be used to document the auditor's tests of controls in a microcomputer environment.

3.327 Sophisticated Computer Systems. In more sophisticated computer systems, the auditor will generally begin by testing general controls. if these controls are weak, no reliance can be placed on application controls.

3.328 General controls over computer systems are generally tested by observation, inquiry, and inspection of documents and control logs. Controls that are most significant include:

- Segregation of duties within the MIS department, so that individuals with knowledge of programs and programming language cannot make unauthorized changes in programs or data,
- Procedures for developing and testing, and implementing new programs, and
- Security controls to prevent unauthorized changes to data by users, e.g., passwords and control logs.

3.329 The procedures used to obtain an understanding of the general controls generally are sufficient to obtain evidence about their operating effectiveness.

3.330 Applications controls are designed to assure the accuracy and completeness of specific data. The controls that are most significant to the auditor include:

- Controls that prevent unauthorized changes to data, such as passwords, user numbers, and control reports,
- Controls that insure the accuracy of data input, such as validity tests of data as it is entered into the system, review of edit reports that summarize changes to data, and control totals,
- Procedures for correcting and reprocessing data that was entered incorrectly, such as follow-up procedures on computer error reports,
- Training of user personnel about how to input data, and
- Adequate user instructions (i.e., in user manuals).

3.331 Application controls in sophisticated computer systems can be tested in a number of ways. The most common approach to testing application controls is described below:

- Observation and inquiry about the use of passwords and the application of validity tests as actual data is entered,
- Inspection of computer output, including error reports and related follow-up,
- Inspection of documents that evidence the review of computer output by appropriate personnel, and
- Inquiry about the training of user personnel and inspection of user instructions.

3.332 The procedures performed in obtaining an understanding of application controls generally are sufficient to allow control risk to be assessed at a level below the maximum. If the client's general and application controls are very effective, these procedures may be sufficient to justify a moderate level of control risk for the related assertions. If the auditor wishes to further reduce the level of control risk, he or she may add tests of controls to the General Applications Computer Controls Questionnaires.

Processing of Transactions by Service Organizations

3.333 SAS No. 70, *Reports on the Processing of Transactions by Service Organizations,* provides guidance to the auditor when his or her client uses a service organization to process a significant application. The Statement also provides guidance for auditors who issue reports on the processing of transactions by service organizations for use by other auditors, but for purposes of this discussion, we will focus on the guidance for auditors whose clients use the service organization.

3.334 When auditing a client that uses a service organization, the auditor should consider the significance that the service organization's policies, procedures, and records have on the client's financial statements. Factors the auditor considers include:

- The financial statement assertions affected by the service organization's processing,
- The nature of the services provided by the service organization,
- The client's internal control policies and procedures that are applied to the transactions processed by the service organization and the availability of auditable data in the client's possession,
- The terms of the contract between the client and the service organization, and
- The service organization's capabilities, including its—
  - — Record of performance
  - — Insurance coverage
  - — Financial stability.

3.335 In many situations the client will have adequate controls over the data processed by the service organization. In these circumstances, there is no need to obtain an understanding of the controls at the service organization. As an example, a client that uses a service bureau to process payroll will usually have adequate controls to provide reasonable assurance that the service bureau is processing the payroll transactions accurately. These controls might consist of a review and testing of the payroll records that are received from the bureau.

3.336 An understanding of the controls at the service organization is generally needed only when the service organization both authorizes and processes transactions. An example of this organization would be a trust (e.g., a pension trust), in which the servicing financial institution makes investment decisions and maintains records of the transactions.

3.337 When the auditor decides that an understanding of the service organization's controls is necessary, this understanding may be obtained by:

- Reviewing manual or system documentation held by the client that describes the service organization's controls over the client's transactions, or
- Obtaining a report from a service auditor who performed procedures at the service organization for the benefit of multiple users.

3.338 In rare circumstances, the auditor may decide that it is necessary to perform procedures at the service organization to gain the required understanding of internal control.

3.339 If the auditor decides that an understanding of the controls at the service organization is necessary and a report by the service auditor is not available, he or she may complete the Service Organization Application Controls Documentation Form, shown in section 10.651.

3.340 If a service auditor report is available, it will be of one of the following two types:

- a report on policies and procedures placed in operation, or
- a report on policies and procedures placed in operation and tests of operating effectiveness.

3.341 Report on Policies and Procedures Placed in Operation. This report addresses the policies and procedures that the service organization has put into effect in the processing of the client's transactions. More specifically, it addresses (1) whether the policies and procedures were suitably designed to achieve specified control objectives, and (2) whether they have been placed in operation as of a specified date. This type of report is useful for obtaining an understanding of the controls at the service organization, but it does not provide evidence to reduce the assessed level of control risk.

3.342 Report on Policies and Procedures Placed in Operation and Tests of Operating Effectiveness. In addition to describing the service organization's controls over the client's transactions, this report addresses the effectiveness of the related controls during the period specified. Therefore, this type of report provides evidence that may allow the user auditor to reduce the assessed level of control risk.

3.343 Evaluating the Service Auditor Report. The Service Auditor Evaluation Form, shown in section 10.652, may be used to evaluate a service auditor report.

Risk of Potential Misstatements Evaluation

3.344 As discussed in Chapter 2, an important consideration in designing an audit strategy is considering the risk that errors, irregularities, and illegal acts that have a material effect on the financial statements could occur. The assessment of this risk, combined with information obtained in completing the Client Acceptance and Continuance Form, the Audit Planning Memorandum, and the Internal Controls Questionnaire, affects the nature, timing, and extent of tests required to reduce that risk to an acceptable level. For example, if the auditor determines that there is a high risk that a material error could occur in a particular area (such as an asset subject to misappropriation or an account that involves very complex accounting methods), he or she would increase the amount of evidence required from tests of controls, analytical procedures, and/or tests of balances for that area. The purpose of the risk evaluation is to direct the auditor's efforts toward the audit areas that are most likely to contain misstatements. Most importantly, this assessment occurs before the evidence collection process begins.

3.345 This early assessment allows the auditor to modify the design of tests before the engagement is completed and overauditing has occurred. For example, the auditor may have planned to test a client's inventories by testing controls in order to reduce year-end inventory count observations, pricing, and clerical tests. A review of the client's prior year's error history, however, revealed that significant counting, pricing, and clerical testing errors had occurred, resulting in a significant extension of the year-end tests. In this case, both extensive tests of controls and tests of balances were required. Had the prior year's errors been identified at the beginning of the engagement, the auditor would have planned to perform primarily substantive tests, rather than waste time and effort on tests of controls that produced unsatisfactory results.

3.346 The Risk of Potential Misstatements Evaluation Form in Chapter 10, section 10.101 is designed to help the auditor assess the likelihood that material misstatements in the financial statements could occur, and if so, to develop an appropriate audit strategy. It should be completed during the pre-engagement audit planning by the in-charge and reviewed by the partner.

3.347 The Form is comprised of two parts. Part I, "Special Considerations," is a series of questions about the client and the audit engagement circumstances that could indicate a high risk of potential misstatements. "Yes" answers to the questions in Part I should be explained. Part II, "Potential Misstatements Matrix," involves assessing the risk of misstatements for each audit area. This assessment is made by considering: (1) the responses to Part I, "Special Considerations," (2) whether the accounts are unusual and material or high risk due to the client's industry and operations, and (3) information from prior years' engagements about high exposure areas and any significant adjustments, made or passed. After considering these three risk categories, the auditor arrives at a conclusion, based on his or her professional judgment as to whether risk is high or low for each area. This conclusion is transferred to the Planning Matrix (section 10.103) where it will be considered in developing an audit strategy. Any situations that indicate a high risk of potential misstatement should be described, along with the planned modification to the tests of controls and substantive tests.

The Planning Matrix

3.348 Completion of the Client Acceptance and Continuance Form, the Audit Planning Memorandum, the Internal Controls Questionnaire, and the Risk of Potential Misstatements Evaluation Form provides the auditor with the information needed to plan the nature, timing, and extent of tests. The Planning Matrix in section 10.103 is designed to bring this information into one form.

3.349 The Planning Matrix contains the following audit areas:

- Cash, including collections and payments
- Trade accounts receivable and sales
- Inventories and purchases

3.350 These are the areas most likely to be tested under a System A or B. In other words, they are areas in which tests of controls is an efficient and effective means of reducing substantive tests. The Matrix should be modified on each engagement to include any other accounts or audit areas for which the System A or B would be more efficient and effective.

3.351 Completion of the Planning Matrix involves the following steps for each audit area:

1. Indicate the preliminary System classification (A, B, or C) from the Internal Controls Questionnaire.
2. Based on the system classification in step 1, select the planned assessed level of control risk. Because a System C lacks good primary and secondary controls, control risk should be assessed at the maximum or slightly below the maximum for these classifications. Control risk for System B classifications can be assessed at a moderate level, and for System A, at a high level. Also, the auditor may elect to use the System C even though the system is evaluated as an A or B if he or she believes it will be more efficient and effective to test those assertions under System C (a primarily substantive approach).
3. From the Risk of Potential Misstatements Matrix, indicate whether the risk of potential misstatements is high or low.

4. Determine whether extensive analytical procedures should be performed to detect material misstatements and indicate whether the risk that they will **not** detect a material misstatement is maximum, moderate, or low.

5. Indicate briefly the nature, timing, and extent of tests of balances.

3.352 Illustration No. 3-5 shows some ways that substantive tests of balances may be reduced when the ABC System is used.

ILLUSTRATION NO. 3-5

REDUCTIONS IN SUBSTANTIVE TESTS OF BALANCES

Audit Areas	Possible TOBs Reductions
1. Cash	1. Prove fewer bank reconciliations. Prove some reconciliations at dates other than balance-sheet date. Trace fewer reconciling items to support. Use client's subsequent bank statement instead of cutoff statement.
2. Accounts receivable confirmation and alternative procedures for nonreplies and exceptions	2. Send fewer confirmations. Confirm at dates other than balance-sheet date. Alternative procedures for nonreplies to positive requests should consist of reviews of subsequent collections. Absent subsequent collections, and in the event of numerous nonreplies, sales and shipping documents should be examined.
3. Sales cutoff	3. Limit the extent of tests of amounts.
4. Physical inventory observation[1]	4. Fewer test counts taken and recorded. More time spent determining client is following instructions. Less time spent on observation. Observe cycle counts for perpetual systems.
5. Tests of balances inventory pricing and clerical tests[1]	5 Limit the extent of the tests.
6. Vouching and inspecting fixed assets	6. Less physical inspection of assets. Limit the extent of vouching tests for additions, repairs, supplies, etc., especially when numerous, low value assets have been capitalized.
7. Search for unrecorded liabilities	7. Higher dollar limits for review of journals, open invoices, receiving reports and purchase order files. Few, if any, vendor confirmations would be sent.
8. Purchases cutoff	8. Limit the extent of tests of amounts.
9. Payroll tests	9. Eliminate monthly or periodic comparison of payroll. Eliminate reconciliation of payroll-to-payroll tax returns.
10. Expense account analysis and vouching	10. Limit the extent of account analysis and vouching.

[1] When client's inventory system is nonperpetual, controls testing of inventory cannot be performed. Observation procedures, pricing, and clerical tests are primarily substantive tests of balances, the extent of which depends on how well client personnel follow written instructions and on the extent of the client's double-checking procedures.

3.400 THE ALL-SUBSTANTIVE APPROACH

3.401 An All-Substantive Approach is characterized by some or all of the following characteristics:

1. Concentration of operational control in the hands of one or a few individuals.
2. Management personnel or employees have limited accounting knowledge.
3. Management believes that it cannot or need not hire employees having accounting knowledge.
4. The potential for management override of internal accounting controls is high.
5. Internal control deficiencies result from:
   a. Limited segregation of functions within the accounting system because of the small number of employees.
   b. Easy access to physical assets by clerical and administrative personnel.
   c. Informally designed procedures for planning, budgeting, accounting, and reporting depend on management style.
6. The entity has an inactive or ineffective board of directors.

3.402 The majority of small and medium size entities possess some or all of these characteristics, making it necessary for the auditor to perform extensive tests of balances to compensate for unacceptable results of tests of controls.

3.403 As mentioned in section 3.111, an auditor may elect to use the All-Substantive Approach on an engagement if he or she decides that such an audit approach would be the most efficient approach. In other words, the nature of the entity's control structure may make performing substantive tests more cost effective than tests of controls.

3.404 In such circumstances, the engagement partner may approve the All-Substantive Approach discussed below. This approach involves assessing control risk at the maximum or slightly below the maximum for all major audit areas. Under this approach, minimal tests of controls are performed and extensive tests of balances and analytical procedures are performed. Even though tests of controls are not required whenever control risk is assessed at the maximum, this approach provides for minimum controls tests through completion of the System C Tests of Controls Programs. Performing these minimum tests of controls is recommended because they can enhance the auditor's understanding of the control structure and flow of transactions through the accounting system, and also allow the auditor to slightly reduce substantive tests.

3.405 Illustration No. 3-6 shows the primary planning and procedural forms that should be completed when using the All-Substantive Approach, along with the corresponding forms used in the ABC System approach.

ILLUSTRATION NO. 3-6

DOCUMENTATION REQUIREMENTS FOR THE ALL-SUBSTANTIVE APPROACH AND THE ABC SYSTEM

All-Substantive Approach	ABC System
Client Acceptance and Continuance Form	Same.
Audit Planning Memorandum	Same.
All-Substantive Approach Questionnaire	Replaces Internal Controls Questionnaire, Risk of Potential Misstatements Evaluation Form, and Planning Matrix.
Materiality Computation Schedule and Summary of Possible Journal Entries Form	Same.
System C Test of Controls Programs (optional)	System A, B, and C Tests of Controls Programs, as evaluated for each audit area.
Internal Control Structure Reportable Conditions Form, based on completion of All-Substantive Approach Questionnaire	Same, but based on Internal Controls Questionnaire.
Tests of Balances Program, highly reliable procedures and maximum sample sizes.	Same, with less reliance if related audit areas are evaluated as Systems A or B.

All-Substantive Approach Questionnaire

3.406 The All-Substantive Approach Questionnaire included in Chapter 10, section 10.200, should be completed on small, noncomplex engagements if it is the most cost-beneficial approach. Section I of the Questionnaire is designed to provide the auditor with an understanding of the entity's internal control structure as required by SAS No. 55. It also helps the auditor identify material control environment and accounting system weaknesses that might impact the design of the audit. "No" answers should be recorded on the Internal Control Structure Reportable Conditions Form in Chapter 10, Section 10.801.

3.407 Section II should be used to evaluate the risk of potential misstatements on the engagement. Areas containing high risk should be described and considered when designing analytical and tests of balances procedures and selecting sample sizes. A high risk of potential misstatements may increase the evidence requirements in certain audit areas.

3.408 Completion of the Internal Controls Questionnaire, the Planning Matrix, and the Risk of Potential Misstatements Evaluation Form is not necessary under the All-Substantive Approach.

Tests of Controls

3.409 Even though tests of controls are not required when control risk is assessed at the maximum, the All-Substantive Approach requires minimum controls testing, using the System C Tests of Controls Programs, to enhance the auditor's understanding of the control structure and flow of transactions. Performing the System C tests of controls may also support an assessment of control risk at slightly below the maximum, allowing the auditor to achieve a slight reduction in tests of balances. The System C Tests of Controls Programs should be selected for all audit areas. Minimum sample sizes may be selected, because minimum reliance is being placed on the tests of controls.

Analytical Procedures

3.410 As for all audit engagements, analytical procedures should be performed on the All-Substantive Approach to the maximum extent practical and should be performed as early in the engagement as possible. On engagements where significant adjustments are required, analytical procedures should be performed after all significant adjustments have been recorded. In each circumstance, the planned reliance on analytical procedures should be reflected in the modification of the Tests of Balances Program.

Tests of Balances

3.411 Because minimum or no tests of controls are performed in a System C, substantive tests become the primary source of evidence. The nature, timing, and extent of the tests of balances and analytical procedures selected should be those that are the most reliable, e.g., positive vs. negative confirmations, larger sample sizes, and tests should be performed at year end rather than at interim dates. Illustration No. 3-7 presents some suggestions that should be considered in designing high-reliance tests of balances for major audit areas.

ILLUSTRATION NO. 3-7

ALL-SUBSTANTIVE APPROACH
SUGGESTED TESTS OF BALANCES

Major Audit Area	Program Design Consideration
1. Cash	1. Prove all major bank reconciliations at the balance-sheet date. Trace most reconciling items to cutoff statements. Search extensively for unrecorded bank transfers.
2. Accounts receivable confirmation and alternative procedures	2. Send positive confirmations for representative accounts comprising a substantial portion of the account balances at year end in accordance with SAS No. 39. Support nonreplies and exceptions by reference to sales and cash receipts documents. Compare sales by month, by product, to preceding years. Follow up on significant fluctuations by inspecting underlying records.
3. Sales cutoff	3. Perform extensive cutoff tests by reference to sales and shipping documents for a large period before and after the balance-sheet date.
4. Physical inventory observation	4. Consider observing inventory from start to finish. Make extensive test counts at all locations.
5. Inventory pricing and clerical tests	5. Perform extensive, representative tests in accordance with SAS No. 39. A significant portion of the inventory items should be subjected to tests.
6. Vouching and inspecting fixed assets	6. Perform extensive vouching and inspections. A significant portion of the fixed assets, repairs, supplies, etc., accounts balances should be subjected to tests.
7. Search for unrecorded liabilities	7. Perform an extensive search for unrecorded liabilities including subsequently recorded transactions, open invoices, receiving reports and purchase order files. Low dollar limits should be used. Consider confirming major suppliers, including zero balances.
8. Purchases cutoff	8. Perform extensive cutoff tests by reference to vendor invoices for a large period before and after the balance-sheet date.
9. Payroll tests	9. Compare monthly payroll by labor category and follow up on transactions by reference to underlying records. Consider predictive analytical procedure or reconciling gross wages to payroll tax returns. Consider observation or payroll distribution.
10. Expense account analysis and vouching	10. Perform extensive vouching tests for all significant account balances by examining canceled checks and supporting documents.

3.500 SAMPLING DECISIONS

Audit Procedure Study and Changes to "Sampling Decisions"

As this Manual goes to print, the Auditing Standards Division of the AICPA is developing an Audit Procedure Study (APS) to replace the AICPA Audit and Accounting Guide, *Audit Sampling*. The APS is expected to be issued by the fourth quarter of 1995.[2]

The guidance contained in this section is consistent with the guidance in the Audit and Accounting Guide except that the "assurance factors" used in the Model Approach (see section 3.533) conform with those used in the draft APS. The authors believe that these factors better reflect current practice.

This section has been revised to make it easier to comply with the requirements of SAS No. 39, *Audit Sampling*. To simplify our coverage of audit sampling for substantive tests, the Table Approach to nonstatistical sampling found in previous editions of this Manual has been removed from this edition of the Manual because the approach is in substance equivalent to the Model Approach. Practitioners who wish to use the Table Approach should refer to the AICPA Audit Sampling Guide. In this regard, the following forms have been deleted:

- Sampling Decision Working Paper
- Sample Size Selection and Evaluation Form
- Attributes Sampling Summary Form
- Nonstatistical Sample Size Selection Matrix—Tests of Controls

3.501 The requirements for audit sampling are included in SAS No. 39, *Audit Sampling* (AU 350), and the AICPA Audit and Accounting Guide, *Audit Sampling* (AAG-SAM).

3.502 According to SAS No. 39, *Audit Sampling* (AU 350), sampling occurs when the auditor tests less than 100% of a population to make some conclusion about the population. SAS No. 39 applies to tests of controls when such tests are performed and to tests of balances when sampling populations are material. The extent to which sampling is used in an audit depends on the size of the client and the nature of the client's internal control structure. If the All Substantive Approach is being used, the auditor will not perform tests of controls using audit sampling. Also, if the sampling populations are small, it is usually more efficient to audit individually significant items and obtain audit assurance about the remaining balance through analytical procedures than to perform audit sampling. As the size and sophistication of the client's internal control structure increases, the auditor is more likely to use audit sampling to perform tests of controls and tests of balances.

[2] The new APS may be obtained by calling the AICPA's Order Department at 1-800-862-4272.

Audit Sampling for Tests of Controls

3.503 SAS No. 39 indicates that an auditor may use nonstatistical or statistical sampling in performing tests of controls. This Manual provides guidance for both approaches. Regardless of whether nonstatistical or statistical sampling is being used, audit sampling for tests of controls involves the following steps:

1. **Determine the objective of the test** — The objective of a test of control is to determine whether a particular internal control policy or procedure is being applied as prescribed. Audit sampling for tests of controls is generally appropriate when application of the internal control policy procedure leaves documentary evidence of performance. Normally, audit sampling for tests of controls will involve selecting a sample of documents and examining them for evidence that the relevant internal control policy or procedure was applied. Tests of controls involving observation of performance of procedures or inquiries of the client are not normally subject to audit sampling.

2. **Define the deviation conditions** — A deviation condition is a situation that indicates that the policy or procedure was not performed. For example, if the auditor is examining purchase invoices for evidence of approval of an expenditure (e.g., the initials of the approving individual), a deviation condition would be an invoice that is not initialed by the appropriate individual. Adequate performance of a policy or procedure consists of all the steps the auditor believes are necessary to support the assessed level of control risk. For example, assume that a prescribed procedure requires that support for every disbursement should include an invoice, a voucher, a receiving report, and a purchase order, all stamped "Paid." The auditor believes that the existence of an invoice and a receiving report, both stamped "Paid," is necessary to indicate adequate performance of the procedure for purposes of supporting the assessed level of control risk. Therefore, a deviation may be defined as "a disbursement not supported by an invoice and a receiving report that have been stamped 'Paid.'"

3. **Define the population** — The population selected must be appropriate for the objective being tested. For example, if the auditor is testing the operating effectiveness of an internal control procedure designed to determine if all shipments were billed, the auditor would not detect deviations by sampling from billed items. An appropriate population for detecting such deviations usually includes the record of all items shipped.

   For samples to be representative of the period under audit, the population generally should include all transactions processed during the period. However, sometimes the results of tests performed at an interim date may be sufficient to generalize about the population for the entire period. In determining whether interim tests are sufficient, the auditor should consider the results of the tests, responses to inquiries concerning the remaining period, the length of the remaining period, the nature and amounts of the transactions or balances involved, and related evidence obtained from the tests of balances. If a control policy or procedure has been changed during the year, the auditor will often decide that it is efficient to only test the new policy or procedure.

   For sample results to be reliable, the sample must be selected from the complete population. Completeness of the population can be determined by either physical or numerical control. Normally, the auditor can establish the completeness of the population by inspecting the documents to see that it appears that they have all been accounted for.

4. **Determine the method of selecting the sample** — Any sample that is selected should be representative of the population and all items should have an opportunity to be selected. Random-number selection should generally be used when statistical sampling is being applied. When nonstatistical sampling is applied, random-number sampling, systematic sampling, and haphazard sampling are methods that might be used to obtain a representative sample. Methods of selecting samples are discussed beginning at section 3.540.

5. **Determine the sample size** — Sample sizes for tests of controls are affected by (1) the risk of assessing control risk too low, (2) the tolerable deviation rate, (3) the expected population deviation rate, and (4) any effects of small population sizes.

   Guidance for determining sample size when performing nonstatistical sampling begins with section 3.506. A description of statistical sampling begins with section 3.509.

6. **Perform the sampling plan** — Once the sample has been selected, the auditor should examine each item for evidence of performance of the internal control policy or procedure. If the auditor selects an item that is unused (e.g., a voided document), the auditor should select another item at random. However, the auditor should make sure that the item really represents an unused item. If the document is valid, but cannot be found, the item should be treated as a deviation in evaluating the sample results.

7. **Evaluate the sample results** — Guidance for evaluating nonstatistical sampling results begins with section 3.507 and guidance for evaluating statistical sampling results begins with section 3.510.

8. **Document the sampling procedure** — The audit working papers should document the following matters:

   - The objectives of the test.
   - A description of the deviation conditions.
   - The acceptable risk of assessing control risk too low.
   - The tolerable deviation rate.
   - The expected deviation rate.
   - The sample results, including the disposition of any deviations found.
   - The effect of the results on the auditors assessed level of control risk.

3.504 Factors Affecting Sample Sizes for Tests of Controls. Sample sizes for tests of controls are affected by the following factors:

1. *Acceptable risk of assessing control risk too low.* The risk of assessing control risk too low is the risk that the sample supports a lower level of control risk than is in fact the case. Decreasing the risk of assessing control risk too low will increase the sample size.

2. *Expected population deviation rate.* The expected population deviation rate represents the rate of deviations the auditor expects to find in the population. As the expected population deviation rate increases, the sample size will increase.

3. *Tolerable deviation rate.* Tolerable deviation rate is the maximum rate (%) of deviations from a control procedure that the auditor is willing to accept without increasing the assessed level of control risk. Higher tolerable deviation rates will permit smaller sample sizes.

4. *Population size.* Populations over 500 items have little or no effect on sample size. For populations under 500 in size, the auditor may slightly reduce the size of the sample.

3.505 The effects of these factors may be summarized as follows:

Factor	Effect on Sample Size
Acceptable risk of assessing control risk too low — increase (decrease)	Smaller (larger)
Tolerable deviation rate — increase (decrease)	Smaller (larger)
Expected population deviation rate — increase (decrease)	Larger (smaller)
Population size	Populations less than 500 items should be adjusted to slightly smaller sample sizes

3.506 Sample Sizes Using Nonstatistical Sampling. Nonstatistical sample sizes for tests of controls may be determined using the sample size selection tables in section 3.507, or they may be selected on a purely judgmental basis. Sample sizes should be entered directly on the appropriate Tests of Controls Program. For each method of selection, the auditor should document consideration of the relevant factors. For example, the rationale for selecting tests of controls sample sizes of 30 from the first table in section 3.507 for an internal control system that is classified as a System B may be:

1. Control risk will be assessed at a moderate level, and

2. The expected population deviation rate is at or near zero.

3.507 The following tables should be used for a nonstatistical approach to determine sample sizes for tests of controls:

CONTROLS TESTING NONSTATISTICAL SAMPLE SIZE SELECTION TABLE

Assessed Level of Control Risk	Sample Size
Maximum	0
Slightly below the maximum	15
Moderate	30
Low	40

The numbers in the table were determined using a risk of assessing control risk too low of 10% and an expected population deviation rate of 0%. When deviations are expected or found in a sample, the following table may be used to determine the sample size or evaluate the sample results:

	Assessment of Control Risk		
Deviations (Expected or Actual)	Slightly Below Maximum	Moderate	Low
0	15	30	40
1	25	50	65
2	34	67	90
3	43	85	115

3.508 In evaluating the results of the sample, the auditor should consider the number of deviations found and the nature of the deviations. If the auditor uses the first table in section 3.507 to determine sample size, the discovery of one or more deviations will require the auditor to reassess the planned level of control risk. In these cases, the second table in section 3.507 may be used to evaluate the assessed level of control risk that is supported by the sample results. When looking at the nature of the deviations, the auditor is concerned with the following questions:

- Was the cause of the deviation an error or does it indicate an intentional violation of the control?
- Are there implications for other audit areas?

3.509 **Sample Sizes Using Statistical Sampling.** The appropriate statistical method for tests of controls is attributes sampling, which is a technique designed to estimate qualitative characteristics of a population. Attributes sampling results may be used to estimate the frequency of deviations from performance of an internal control policy or procedure.

3.510 Applying attributes sampling involves performing the following steps:

1. **Decide on the attributes to test.** The Tests of Controls Program may include the testing of one or more attributes. Proper evaluation of the results may require testing and evaluating each attribute separately.
2. **Define the population from which the sample items should be selected.** The auditor should make sure that the population is appropriate for the audit objective as described in section 3.503.
3. **Specify the following factors:**
   - *Acceptable Risk of assessing control risk too low*. The risk of assessing control risk too low is the risk the sample supports a lower level of control risk than is the case. Since sample evidence represents the only evidence typically obtained about the operating effectiveness of a particular control, the risk of assessing control risk too low is usually set at 5% or 10%.

- *Tolerable deviation risk.* Tolerable deviation rate is the maximum rate (%) of deviations from a control procedure the auditor is willing to accept without increasing the assessed level of control risk. Higher assessments of control risk will permit higher tolerable deviation rates as shown in the following table:

Planned Assessed Level of Control Risk	Tolerable Rate
Low	2% - 7%
Moderate	6% - 12%
Slightly below the maximum	11% - 20%
Maximum	Omit test

- *Expected population deviation rate.* The expected population deviation rate represents the rate of deviations the auditor expects to find in the population. The auditor's expectations may be based on prior years' experience with the client, or experience with similar clients. Sample sizes will increase significantly as the expected population deviation rate increases from zero. If the deviation rate in the sample turns out to be higher than the rate specified by the auditor in determining the sample size, the sample results will not support the auditor's planned assessed level of control risk.

4. **Determine the appropriate size sample.** Sample sizes are found in the tables in sections 3.511 through 3.512. The table in section 3.511 is designed for a risk of assessing control risk too low of 5%, and the table in section 3.512 is designed for a 10% risk of assessing control risk too low. With the tolerable deviation rate and the expected deviation rate, the auditor may find the sample size from the table. The numbers in parentheses are the number of deviations that may be found in the sample and still support the auditor's planned assessed level of control risk.

5. **Randomly select the sample from the population.** The section beginning at section 3.540 describes the methods that may be used to select a random sample.

6. **Perform the audit procedures to identify deviations in the sample.**

7. **Calculate the statistical results.** Using the tables in sections 3.513 through 3.514 the appropriate risk of assessing control risk too low, determine the actual tolerable deviation rate from the sample size and the actual number of deviations found in the sample.

8. **Reassess the level of control risk.** If the actual deviation rate in the sample is higher than that specified in determining the sample, the sample results will not support the auditor's planned assessed level of control risk. In these situations, the auditor should increase the assessed level of control risk. The auditor should also consider the causes of the deviations found, and whether they have implications for other audit areas.

9. **Document the Sampling Procedures.** The audit working papers should document the matters set forth in section 3.503 (Item 8).

3.511

Statistical Sample Sizes for Testing Controls
Five Percent Risk of Assessing Control Risk Too Low
(with number of expected deviations in parentheses)

Tolerable Rate

Expected Population Deviation Rate	2%	3%	4%	5%	6%	7%	8%	9%	10%	15%	20%
0.00%	149(0)	99(0)	74(0)	59(0)	49(0)	42(0)	36(0)	32(0)	29(0)	19(0)	14(0)
.25	236(1)	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
.50	*	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
.75	*	208(2)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.00	*	*	156(2)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.25	*	*	156(2)	124(2)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.50	*	*	192(3)	124(2)	103(2)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.75	*	*	227(4)	153(3)	103(2)	88(2)	77(2)	51(1)	46(1)	30(1)	22(1)
2.00	*	*	*	181(4)	127(3)	88(2)	77(2)	68(2)	46(1)	30(1)	22(1)
2.25	*	*	*	208(5)	127(3)	88(2)	77(2)	68(2)	61(2)	30(1)	22(1)
2.50	*	*	*	*	150(4)	109(3)	77(2)	68(2)	61(2)	30(1)	22(1)
2.75	*	*	*	*	173(5)	109(3)	95(3)	68(2)	61(2)	30(1)	22(1)
3.00	*	*	*	*	195(6)	129(4)	95(3)	84(3)	61(2)	30(1)	22(1)
3.25	*	*	*	*	*	148(5)	112(4)	84(3)	61(2)	30(1)	22(1)
3.50	*	*	*	*	*	167(6)	112(4)	84(3)	76(3)	40(2)	22(1)
3.75	*	*	*	*	*	185(7)	129(5)	100(4)	76(3)	40(2)	22(1)
4.00	*	*	*	*	*	*	146(6)	100(4)	89(4)	40(2)	22(1)
5.00	*	*	*	*	*	*	*	158(8)	116(6)	40(2)	30(2)
6.00	*	*	*	*	*	*	*	*	179(11)	50(3)	30(2)
7.00	*	*	*	*	*	*	*	*	*	68(5)	37(3)

* Sample Size is too large to be cost effective for most audit applications.
Derived from AICPA Audit and Accounting Guide, *Audit Sampling*.
NOTE: This table assumes a large population.

3.512

Statistical Sample Sizes for Testing Controls
Ten Percent Risk of Assessing Control Risk Too Low
(with number of expected deviations in parentheses)

Tolerable Rate

Expected Population Deviation Rate	2%	3%	4%	5%	6%	7%	8%	9%	10%	15%	20%
0.00%	144(0)	76(0)	57(0)	45(0)	38(0)	32(0)	28(0)	25(0)	22(0)	15(0)	11(0)
.25	194(1)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
.50	194(1)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
.75	265(2)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.00	*	176(2)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.25	*	221(3)	132(2)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.50	*	*	132(2)	105(2)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.75	*	*	166(3)	105(2)	88(2)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
2.00	*	*	198(4)	132(3)	88(2)	75(2)	48(1)	42(1)	38(1)	25(1)	18(1)
2.25	*	*	*	132(3)	88(2)	75(2)	65(2)	42(1)	38(1)	25(1)	18(1)
2.50	*	*	*	158(4)	110(3)	75(2)	65(2)	58(2)	38(1)	25(1)	18(1)
2.75	*	*	*	209(6)	132(4)	94(3)	65(2)	58(2)	52(2)	25(1)	18(1)
3.00	*	*	*	*	132(4)	94(3)	65(2)	58(2)	52(2)	25(1)	18(1)
3.25	*	*	*	*	153(5)	113(4)	82(3)	58(2)	52(2)	25(1)	18(1)
3.50	*	*	*	*	194(7)	113(4)	82(3)	73(3)	52(2)	25(1)	18(1)
3.75	*	*	*	*	*	131(5)	98(4)	73(3)	52(2)	25(1)	18(1)
4.00	*	*	*	*	*	149(6)	98(4)	73(3)	65(3)	25(1)	18(1)
5.00	*	*	*	*	*	*	160(8)	115(6)	78(4)	34(2)	18(1)
6.00	*	*	*	*	*	*	*	182(11)	116(7)	43(3)	25(2)
7.00	*	*	*	*	*	*	*	*	199(14)	52(4)	25(2)

* Sample Size is too large to be cost effective for most audit applications.
Derived from AICPA Audit and Accounting Guide, *Audit Sampling*.
NOTE: This table assumes a large population.

3.513

Statistical Sample Results Evaluation
Table for Tests of Controls
Tolerable Deviation Rate at Five Percent Risk of Assessing Control Risk Too Low

Actual Number of Deviations Found

Sample Size	0	1	2	3	4	5	6	7	8	9	10
25	11.3	17.6	*	*	*	*	*	*	*	*	*
30	9.5	14.9	19.6	*	*	*	*	*	*	*	*
35	8.3	12.9	17.0	*	*	*	*	*	*	*	*
40	7.3	11.4	15.0	18.8	*	*	*	*	*	*	*
45	6.5	10.2	5.4	16.4	19.2	*	*	*	*	*	*
50	5.9	9.2	12.1	14.8	17.4	19.9	*	*	*	*	*
55	5.4	8.4	11.1	5.5	15.9	18.2	*	*	*	*	*
60	4.9	7.7	10.2	12.5	14.7	16.8	18.8	*	*	*	*
65	4.6	7.1	9.4	11.5	5.6	15.5	17.4	19.3	*	*	*
70	4.2	6.6	8.8	10.8	12.6	14.5	16.3	18.0	19.7	*	*
75	4.0	6.2	8.2	10.1	11.8	5.6	15.2	16.9	18.5	20.0	*
80	3.7	5.8	7.7	9.5	11.1	12.7	14.3	15.9	17.4	18.9	*
90	3.3	5.2	6.9	8.4	9.9	11.4	12.8	14.2	15.5	16.8	18.2
100	3.0	4.7	6.2	7.6	9.0	10.3	11.5	12.8	14.0	15.2	16.4
125	2.4	3.8	5.0	6.1	7.2	8.3	9.3	10.3	11.3	12.3	5.2
150	2.0	3.2	4.2	5.1	6.0	6.9	7.8	8.6	9.5	10.3	11.1
200	1.5	2.4	3.2	3.9	4.6	5.2	5.9	6.5	7.2	7.8	8.4

* Over 20 percent.

Derived from AICPA Audit and Accounting Guide, *Audit Sampling*.

NOTE: This table presents upper limits as percentages. This table assumes a large population.

3.514

Statistical Sample Results Evaluation Table for Tests of Controls Tolerable Deviation Rate at Ten Percent Risk of Assessing Control Risk Too Low

Actual Number of Deviations Found

Sample Size	0	1	2	3	4	5	6	7	8	9	10
20	10.9	18.1	*	*	*	*	*	*	*	*	*
25	8.8	14.7	19.9	*	*	*	*	*	*	*	*
30	7.4	12.4	16.8	*	*	*	*	*	*	*	*
35	6.4	10.7	14.5	18.1	*	*	*	*	*	*	*
40	5.6	9.4	12.8	16.0	19.0	*	*	*	*	*	*
45	5.0	8.4	11.4	14.3	17.0	19.7	*	*	*	*	*
50	4.6	7.6	10.3	12.9	15.4	17.8	*	*	*	*	*
55	4.1	6.9	9.4	11.8	14.1	16.3	18.4	*	*	*	*
60	3.8	6.4	8.7	10.8	12.9	15.0	16.9	18.9	*	*	*
70	3.3	5.5	7.5	9.3	11.1	12.9	14.6	16.3	17.9	19.6	*
80	2.9	4.8	6.6	8.2	9.8	11.3	12.8	14.3	15.8	17.2	18.6
90	2.6	4.3	5.9	7.3	8.7	10.1	11.5	12.8	14.1	15.4	16.6
100	2.3	3.9	5.3	6.6	7.9	9.1	10.3	11.5	12.7	5.9	15.0
120	2.0	3.3	4.4	5.5	6.6	7.6	8.7	9.7	10.7	11.6	12.6
160	1.5	2.5	3.3	4.2	5.0	5.8	6.5	7.3	8.0	8.8	9.5
200	1.2	2.0	2.7	3.4	4.0	4.6	5.3	5.9	6.5	7.1	7.6

* Over 20 percent.

Derived from AICPA Audit and Accounting Guide, *Audit Sampling*.

NOTE: This table presents upper limits as percentages. This table assumes a large population.

Audit Sampling for Tests of Balances

3.515 In planning tests of balances, the auditor should decide on the most efficient approach to performing the tests. For some recorded populations, instead of sampling, it may be more efficient to examine individually significant items comprising a majority, or near majority, of the recorded population. Audit assurance about the remaining balance may then be obtained by (1) performing analytical procedures, or (2) concluding that the risk of material misstatement of the remaining balance is low. For example, confirmation of 50% to 80% of the dollar amount of accounts receivable may be necessary when risk is high; 40% to 60% may be sufficient when risk is low.

3.516 Obviously, when the remaining balance, after auditing the individually significantly items, is immaterial, no testing of the remaining balance is necessary.

3.517 The decision to sample, or not to sample, should be documented in the Audit Planning Memorandum (Chapter 10, section 10.300).

3.518 Selecting all individually significant items is not considered a sampling application. Items such as large receivables are usually examined individually. Procedures used for examining such items should ordinarily be the most reliable under the circumstances, such as positive confirmation requests.

3.519 When planning a sampling application for tests of balances, the in-charge should consider the financial statement assertions and audit objectives and their relationship to populations selected. For example, understatements cannot be detected by sampling recorded amounts; instead, units from populations of all existing transactions must be selected. The populations, and the appropriate sampling units, are described in the Tests of Balances Program (Chapter 10, section 10.700).

3.520 The following is an approach to nonstatistical sampling for tests of balances.

1. Determine the sampling population by identifying and deducting the individually significant items.
2. Determine the sample size by considering the following factors:
   - The amount of tolerable misstatement.
   - The assessed level of inherent and control risk for the assertions being tested.
   - The risk that other substantive procedures (e.g., analytical procedures) will fail to detect a material misstatement.
   - Variations within the population.
3. Select the sample.
4. Perform the test procedure.
5. Evaluate the results.
   - Project the misstatement.
   - Consider sampling risk.
   - Consider qualitative aspects of the test results.

6. Document the sample procedure when using the Model Approach described in sections 3.528 through 3.529, the Model Approach Working Paper — Tests of Balances Sampling (see section 3.706) and the Audit Sampling Evaluation Form — Tests of Balances Sampling (see section 3.707) may be used for this purpose.

3.521 Sample selection methods should produce representative samples and may include random selection, systematic selection, or haphazard selection methods. Care should be taken to avoid bias when a haphazard selection method is used. Section 3.540 describes these sample selection methods.

3.522 Determine the Sample Size for Tests of Balances. Sample sizes for tests of balances are affected by the following factors:

- *Tolerable misstatement.* As the amount of tolerable misstatement increases, the sample size decreases. Conversely, larger sample sizes are required to compensate for a smaller amount of tolerable misstatement. The tolerable misstatement for a sampling application may be taken from the Materiality Computation Form in Chapter 10, section 10.301.
- *Assessed level of inherent and control risk.* As the combined level of inherent and control risk increases, the sample size increases. Assessments of inherent and control risk may be obtained by reviewing the Planning Matrix (see section 3.702).
- *The risk that other substantive procedures will fail to detect a material misstatement.* As the risk that other substantive procedures will fail to detect a material misstatement increases, the sample size increases. This risk is determined by considering the effectiveness of these procedures.
- *Variations within the population.* Sample sizes are smaller when the sampling population is stratified into homogeneous groups. Larger sample sizes are usually required to obtain a representative sample from sampling populations with high variations.

3.523 Illustration No. 3-8 summarizes the impact of the factors above on sample size planning.

ILLUSTRATION NO. 3-8

FACTORS INFLUENCING SAMPLE SIZES FOR SUBSTANTIVE TESTS OF BALANCES

	Conditions Leading to:	
Factor	Smaller Sample Size	Larger Sample Size
a. Tolerable misstatement	Larger amount.	Smaller amount.
b. Assessed level of inherent and control risk.	Lower.	Higher.
c. Risk that other procedures will fail to detect a material misstatement.	Lower.	Higher.
d. Population variation.	Less variation.	More variation.

3.524 Nonstatistical Sampling Approaches. At the direction of the engagement partner, either of the following nonstatistical approaches can be used for selecting tests of balances sample sizes:

1. Judgmental method.
2. Model approach.

3.525 Judgmental Method. Sample sizes can be selected judgmentally after considering the influence of the factors described above. The in-charge should describe, in the Audit Planning Memorandum, the factors that influence the sample sizes selected for substantive tests of balances. The engagement partner should approve the planned sample sizes before the substantive tests of balances work is begun. See Chapter 10, section 10.300 for an illustrative Audit Planning Memorandum.

3.526 Judgmentally selected samples are considered in terms of audit coverage of a total population. Large dollar coverage generally includes individually significant items, and units from the sampling population that cover more than 50% of the dollar amount of the total population.

3.527 The coverage of the total population will also be affected by the nature of the population and the degree of the engagement risks. For example, a large coverage of accounts receivable for confirmation in high-risk circumstances may be from 50% to 80% of the total dollar population. A large coverage for an inventory price test in the same circumstances may only be 30% to 40% of total inventory because the risk of inventory price misstatement is generally less. In low-risk circumstances, a large coverage of accounts receivable may be 40% to 60%, a large inventory coverage may be 20% to 30%. These percentages are not presented as specific guidelines for decision making, but as illustrations of the factors influencing nonsampling decisions. Since the auditor's opinion is expressed on the financial statements taken as a whole, evidence should be designed to include tests of a majority of the dollars in the financial statements, but should also be, overall, the most efficient in the circumstances.

3.528 The Model Approach. The model approach is a nonstatistical sampling method that is based on Probability-Proportion-To-Size (PPS) Sampling. Because the approach is based on PPS theory, the overall materiality limit does not have to be allocated to each account to determine tolerable misstatements. Instead, the basic allowance for unknown misstatement, i.e., overall materiality limit minus estimates for unadjusted misstatement from nonsampling tests, expected projected misstatement from sampling tests and related allowances for imprecision, may be used in place of tolerable misstatement for each sampling application. An acceptable approach would be to use 66⅔%, or a smaller percentage, of the overall materiality limit for the basic allowance. (See the Materiality Computation Form in Chapter 10, section 10.301). Under PPS theory, the overall materiality limit does not have to be allocated to accounts because the financial statements may be viewed as one population and the basic allowance for unknown error applies to the financial statements taken as a whole. The basic allowance must also be considered, however, when measuring misstatements on the Summary of Possible Journal Entries Form.

3.529 It is important to recognize that when sample sizes are selected nonstatistically based on some statistical theory such as PPS, it is assumed that the population will be stratified. A simple method of stratification is as follows:

- Determine the mean of the population to be sampled.
- Select 2/3 of the sample items from those items equal to or greater than the mean.
- Select 1/3 of the sample items from those items less than the mean.

3.530 If it is not practical to stratify the sampling population, the sample size should be increased by a factor of 20%, or multiplied by 1.2.

3.531 A more time consuming, yet more accurate method would, of course, be a PPS statistical selection method. For the sake of time, however, this statistical method ordinarily is not used. When populations are unusually large and engagement risks are high, however, a PPS statistical method may be appropriate. Guidance for PPS statistical sampling may be found in the AICPA Audit and Accounting Guide, *Audit Sampling*.

3.532 Developed from the model in the AICPA Audit Sampling Guide (paragraphs 4.57 to 4.60), the Model Approach follows:

$$\frac{\text{Sampling Population}}{\text{Tolerable Misstatement}} \times \text{Assurance Factor} = \text{Preliminary Sample Size (units)}$$

$$\text{Preliminary Sample Size (Units)} \times \text{Marginal Risk Factors (1.2 to 1.5)} = \text{Adjusted Sample Size (units)}$$

3.533 The assurance factors, also based on PPS statistical theory, are as follows:

	Risk that other substantive procedures (e.g., analytical procedures will fail to detect a material misstatement		
Assessment of inherent and control risk	Maximum	Moderate	Low
Maximum	3.0	2.3	1.9
Slightly below maximum	2.7	2.0	1.6
Moderate	2.3	1.6	1.2
Low	1.9	1.2	1.0

3.534 The steps to be taken in determining the sample size using the Model Approach Working Paper Tests of Balances Sampling Form (see section 10.503) are as follows:

A. Assess the combination of inherent and control risk:

1. Maximum — Control and inherent risk are assessed at the maximum for the particular assertions. No tests of controls are required to support this assessment.

2. Slightly below the maximum — Control and inherent risk are assessed at slightly below the maximum for the particular assertions. Minimal tests of controls are required for this assessment.

3. Moderate — Control and inherent risk are assessed at a moderate level for this particular assertion. Moderately effective tests of controls are required for this assessment.

4. Low — Control and inherent risk are assessed at a low level for the particular assertions. Very effective tests of controls are required for this assessment.

B. Determine the basic allowance for unknown misstatements (tolerable misstatement). This is related to preliminary estimates of materiality for the engagement.

C. Assess the risk that other substantive procedures (such as analytical procedures) designed to test the same assertions will fail to detect a material misstatement in a particular assertion as follows:

1. Maximum — No other substantive procedures are performed that are designed to test the same assertions.

2. Moderate — Other substantive procedures to test the assertions are expected to be moderately effective in detecting material misstatements.

3. Low — Other substantive procedures to test the assertions are expected to be highly effective in detecting material misstatements.

D. Determine the population's recorded amount after deducting any items that will be audited 100% (all items that are more than 1/3 of tolerable misstatement).

E. Use the appropriate assurance factor and the formula to determine the initial sample size.

3.535 Depending on the amount of the basic allowance for unknown misstatements, sample sizes computed with this model may approximate those sizes selected judgmentally. Because the model is based on a highly stratified approach, and this approach usually will include minimal or no stratification, the sample should be somewhat larger than the preliminary size if there are significant variations in the population. If stratification is necessary and is not practical, an acceptable approach would be to multiply the preliminary sample size by a marginal risk factor of 1.2 to compensate for the sampling risk associated with not stratifying. The marginal risk factor should *not* be used when the population is stratified or when stratification is not necessary.

3.536 **Evaluating the Sample Results.** The misstatement in the sample must be projected to the population. One method of projecting the amount of misstatement found in a sample is to divide the amount of misstatement by the fraction of total dollars in the population to total dollars included in the sample. For example, if a $1,000 misstatement is found in a sample of 10 percent of the population, the projected misstatement would be $10,000 ($1,000/.10).

3.537 A second method for projecting the misstatement uses the average difference between the audited and the recorded amounts of each item included in the sample. For example, if $200 of misstatement is found in a sample of 100 items, the average difference between audited and recorded amounts for items in the sample is $2 ($200/100). An estimate of the amount of misstatement in the population may be calculated by multiplying the total number of items in the population (in this case 25,000 items) by the average difference of $2 for each sample item. The estimate of misstatement in the population is $50,000 (25,000 x $2).

3.538 If the projected misstatement is less than tolerable misstatement for the account balance, consideration must be given to the risk that actual misstatement exceeds the amount of tolerable misstatement. If the projected misstatement is less than 1/3 of tolerable misstatement, it is generally safe to conclude that sampling risk is sufficiently low. If it is greater than 1/3, consideration should be given to performing additional tests of the account.

3.539 The Audit Sample Evaluation Form — Tests of Balances (section 10.504) is designed to project the misstatement in the sample to the population, and to evaluate sampling risk. The form should be completed by the in-charge and reviewed by the engagement partner. Remember that any projected misstatement should be posted to the Summary of Possible Journal Entries Form.

Selecting Samples

3.540 SAS No. 39 permits random number selection, systematic selection with or without random starts and haphazard selection methods for nonstatistical sampling. Block sampling is not acceptable. A random number selection method should be used for statistical sampling.

3.541 Random-based selection methods can be applied using random number tables or computer or calculator programs. The Random Selection With a Random Table Form (see section 10.501) may be used to document sample size selections using a random number table.

3.542 To use a random number table:

1. Assign each element in the population a unique address that corresponds to the random number table.
2. Decide how to read the table, i.e., the number of digits and location, and if top to bottom, left to right.
3. Place a pencil on a page to determine a random starting point.
4. Modify the population numbers to the smallest possible number of digits to reduce discards.

3.543 The procedure for using a program or calculator to generate random numbers varies with the programs. However, these techniques generally require the auditor to provide the smallest and largest item numbers, and the number of sample items needed.

3.544 Systematic sampling requires the calculation of an interval. An interval is determined by dividing the population size by the number of sample units desired. For example:

$$\begin{aligned} N &= \text{Sample Size} = 4{,}000 \\ n &= \text{Desired Units} = 50 \\ I &= \text{Interval} \\ I &= \frac{N}{n} = \frac{4{,}000}{50} = 80 \end{aligned}$$

3.545 After selecting a random number within the interval as a starting point, each 80th unit would be selected. A Random Selection With a Systematic Sample Form in section 10.502 may be used to document systematic selection methods with random starts.

3.546 Haphazard sampling involves selecting items on a purely judgmental basis, without any bias towards the selection of particular items.

Performing Compilation and Review Engagements

CHAPTER 4

PERFORMING COMPILATION AND REVIEW ENGAGEMENTS

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CHAPTER 4

PERFORMING COMPILATION AND REVIEW ENGAGEMENTS

4.000 COMPILATION ENGAGEMENTS

What Is a Compilation?

4.001 A compilation of financial statements is defined in paragraph 4 of Statement on Standards for Accounting and Review Services (SSARS) No. 1, *Compilation and Review of Financial Statements*, (AR 100.04) as "presenting in the form of financial statements information that is the representation of management (owners) without undertaking to express any assurance on the statements." SSARS No. 1 clearly states that performing a compilation does not include making inquiries or performing other procedures to verify, corroborate, or review the information supplied by the client. Likewise, the accountant does not have to obtain an understanding of the client's internal control structure or assess control risk. This does not mean that the accountant can compile financial statements that are known to be misleading. If the accountant becomes aware that information supplied by the client is incorrect, incomplete, or otherwise unsatisfactory, he or she should obtain additional or revised information. If the client refuses to provide additional or revised information, the accountant should withdraw from the engagement.

What Are the Requirements of a Compilation?

4.002 SSARS No. 1 includes several performance requirements for a compilation of financial statements, including the following:

- Establish an understanding with the client, preferably in writing, regarding the services to be performed.
- Possess or obtain a level of knowledge of the accounting principles and practices of the industry in which the client operates.
- Possess or obtain a general understanding of the nature of the client's business transactions, the form of its accounting records, the stated qualifications of its accounting personnel, and the accounting basis and form and content of the financial statements.
- Consider whether it is necessary to perform other accounting services to be able to compile the financial statements.
- Read the compiled financial statements and consider whether they appear to be appropriate in form and free from obvious material misstatements.

- Request additional or revised information when the information provided by the client appears to be incorrect, incomplete, or otherwise unsatisfactory.

4.003 A flowchart for performing compilation services is set forth in Chapter 1, Illustration No. 1-2.

Consider the Need to Perform Other Accounting Services

4.004 The accountant should never compile financial statements from accounting records that are likely to be materially incorrect or incomplete because the client's personnel have not or cannot maintain appropriate records. Therefore, based on his or her knowledge of the client, the accountant may find it necessary to arrange to perform additional services to update or adjust the client's accounting records before compiling the financial statements.

Request Additional or Revised Information

4.005 Although the accountant is not required to perform any procedures to verify information supplied by the client, he or she may become aware that information provided is incorrect, incomplete, or otherwise unsatisfactory. In such circumstances, the accountant should obtain additional or revised information. If the client refuses to provide additional or revised information, the accountant should withdraw from the compilation engagement. This requirement does not apply to information that is not needed because management has elected to omit substantially all of the disclosures required by generally accepted accounting principles.

Read the Compiled Financial Statements

4.006 The required reading of the financial statements is designed to bring the accountant's knowledge of industry accounting principles and the client's business to bear on the financial statement presentation. In reading the financial statements, the accountant should be alert for arithmetical or clerical errors and mistakes in the application of accounting principles, including inadequate disclosure.

4.100 REVIEW ENGAGEMENTS

What Is a Review?

4.101 SSARS No. 1 created a service that permits an accountant to express limited assurance on the financial statements of a nonpublic entity. That service is a review. Paragraph 4 of SSARS No. 1 (AR 100.04) defines a review as—

> Performing inquiry and analytical procedures that provide the accountant with a reasonable basis for expressing limited assurance that there are no material modifications that should be made to the statements in order for them to be in conformity with generally accepted accounting principles or, if applicable, with an other comprehensive basis of accounting.

4.102 A review differs from a compilation in two principal ways. First, the accountant expresses limited assurance in a review, whereas no assurance is expressed in a compilation. Second, the accountant is required to perform specific types of procedures in a review — inquiries and analytical procedures — to obtain a reasonable basis for expressing that assurance. Also, in a review, the accountant must obtain a signed client representation letter. In a compilation, no specific procedures, other than reading the financial statements, are required.

What Are the Requirements of a Review?

4.103 An accountant who reviews financial statements must meet five specific performance requirements as well as certain reporting requirements. In general, these requirements are:

- Establish an understanding with the entity regarding the services to be performed and the report the accountant expects to render.
- Have or obtain knowledge of the accounting principles and practices of the entity's industry and an understanding of the entity's business that will provide him or her, through the performance of inquiry and analytical procedures, with a reasonable basis for expressing limited assurance.
- Perform inquiry and analytical procedures sufficient to provide a reasonable basis for expressing limited assurance.
- Perform additional procedures when the accountant becomes aware that information supplied by the entity is incorrect, incomplete, or otherwise unsatisfactory. These procedures should be sufficient to achieve limited assurance.
- Obtain a representation letter from the owner, manager, or chief executive officer, and, if appropriate, the chief financial officer.
- Consider whether to modify his or her report if in the review of the financial statements the accountant becomes aware of a departure from generally accepted accounting principles (GAAP) that is material to the financial statements and the financial statements are not revised.

4.104 A flowchart for performing review services is presented in Chapter 1, Illustration No. 1-3.

4.200 ESTABLISHING AN UNDERSTANDING WITH THE CLIENT

4.201 Once the accountant has decided to accept a review engagement, he or she should establish an understanding with the client, preferably in writing, regarding the services to be performed, the terms and objectives of the engagement, and the type of report anticipated.

4.300 KNOWLEDGE OF THE INDUSTRY AND BUSINESS

4.301 To perform a review the accountant is required to have a knowledge of the accounting principles and practices of the industry in which the client operates and an understanding of the client's business. Similar requirements exist when the accountant performs a compilation service. However, *greater knowledge* of these two areas is necessary for a review than for a compilation.

4.302 The reason for the difference in knowledge requirements stems from the difference in the objectives of the two engagements. In a compilation, the accountant must have sufficient knowledge to put financial information in the form of financial statements, but in a review the accountant's knowledge must be sufficient to express, in conjunction with inquiry and analytical procedures, limited assurance on the financial statements.

Knowledge of the Client's Industry

4.303 To review financial statements, the accountant should know enough about the accounting principles and practices in the client's industry both to understand the proper form and content of its financial statements and to design, perform, and evaluate the results of the inquiry and analytical procedures necessary to achieve limited assurance.

4.304 In the authors' opinion, this does not mean that the accountant must be a specialist in the client's industry. It simply requires that the accountant be familiar with the accounting principles and practices particular to that industry. Such a familiarity is necessary to properly apply the inquiry and analytical procedures required in a review.

4.305 SSARS No. 1 does not require the accountant to possess industry knowledge prior to accepting a review engagement. As long as the accountant obtains the required knowledge before the review is completed, the SSARS requirement is satisfied. A number of sources usually are available to the accountant to assist in obtaining industry knowledge. AICPA accounting and audit guides, industry publications, financial statements of other entities in the industry, textbooks and periodicals, and consultation with individuals knowledgeable about the industry are examples of common sources.

Knowledge of the Client's Business

4.306 Paragraph 26 of SSARS No. 1 (AR 100.26) requires the accountant to have a general understanding of the client's business in the following specific areas:

- The entity's organization
- The entity's operating characteristics
- The nature of the entity's assets, liabilities, revenues, and expenses

4.307 The paragraph goes on to state that knowledge of the business also normally includes a general understanding of the entity's production, distribution, and compensation methods; types of products and services; operating locations; and material transactions with related parties.

4.308 To determine how much knowledge of the entity's business is necessary to perform a review, emphasis should be placed on the term *general understanding* used in SSARS. The term general understanding means an overall familiarity or awareness, not an in-depth knowledge. Completing the Client Acceptance and Continuance Form (Chapter 10, section 10.000), the Form for Documenting Understanding of Client's Business and Industry — Compilation and Review Engagements (section 10.901), and the Form For Documenting Understanding of Client's Business and Industry — Supplement for Review Engagements (section 10.902), will ordinarily provide an understanding of the client's business that meets the requirements of SSARS.

4.309 The accountant usually obtains an initial understanding of the client's business by making inquiries and observations and looking at relevant documents. After obtaining the initial understanding, the accountant need only update it in succeeding engagements.

4.400 CLIENT REPRESENTATION LETTERS

4.401 SSARS No. 7, *Omnibus Statement on Accounting and Review Services—1992*, requires, among other things, that an accountant obtain a representation letter in all review engagements. Because review engagements provide limited assurance about the financial statements, such letters provide useful evidence for developing that assurance. A sample representation letter for a review engagement is presented in Chapter 13, section 13.033.

4.500 INQUIRIES

4.501 Inquiries involve asking questions of entity personnel about significant financial statement matters. For inquiries to be effective, they should be directed to entity personnel who are likely to be knowledgeable about the subject of the inquiry — that is, persons having responsibility for financial and accounting matters.

4.502 Although inquiries must be made in a review, the accountant has considerable flexibility in determining their nature and extent. Factors the accountant should consider when deciding which inquiries to make include (1) knowledge acquired in current and previous engagements, (2) the nature and materiality of financial statement items, (3) the likelihood of misstatement in a financial statement item, (4) the stated qualifications of accounting personnel, (5) the extent to which a particular item is affected by management's judgment, and (6) inadequacies in the entity's underlying financial data.

4.503 Paragraph 27 of SSARS No. 1 (AR 100.27) identifies the following major areas for the accountant's inquiries:

- The entity's accounting principles and practices and the methods of applying them.
- The entity's procedures for recording, classifying, and summarizing transactions, and accumulating information for disclosure in the financial statements.
- Actions taken at meetings of stockholders, board of directors, committees of the board of directors, or comparable meetings that may affect the financial statements.

- Whether the financial statements have been prepared in conformity with GAAP consistently applied.
- Whether there have been changes in the entity's business activities or accounting principles and practices.
- Matters about which questions have arisen in the course of applying review procedures, including analytical procedures.
- Events subsequent to the date of the financial statements that would have a material effect on the financial statements.

4.504 The Review Engagement Work Program in Chapter 10, section 10.904 presents typical inquiries that may be made in a review. These inquiries pertain to common financial statement accounts and areas described in SSARS No. 1. However, as stated in the instructions to the work program, the accountant might decide to omit some inquiries or add others based on the factors noted in Chapter 4, section 4.502.

4.600 ANALYTICAL PROCEDURES

4.601 Analytical procedures are performed to help the accountant identify relationships and individual items that appear to be unusual. The absence or explanation of unusual relationships or items provides evidence that helps the accountant obtain limited assurance about the financial statements. Paragraph 27 of SSARS No. 1 (AR 100.27) identifies three major categories of analytical procedures.

Comparing the Financial Statements With Financial Statements for Comparable Prior Period(s)

4.602 These comparisons usually involve comparing significant absolute amounts in the current period financial statement accounts with those same accounts in comparable prior financial statements. For example, the accountant might compare current receivable, inventory, property, revenue, and expense amounts with prior period amounts to determine whether unusual or unexpected differences exist. Analyzing the trends in accounts over two or more periods by computing percentage changes is a common analytical procedure for this type of comparison.

4.603 Such comparisons should be made with *comparable* prior periods for the procedures to be effective. In addition, the accountant should consider making these comparisons on a monthly basis or by operating unit or product line to improve their effectiveness in detecting misstatements that occur in one or two months, in operating units, or in product lines.

Practice Tip:

A client may significantly change the nature of its business, making comparisons with financial data from prior periods irrelevant. In such circumstances, you should not waste time making those comparisons. Additional inquiries and other analytical procedures should be performed to provide a basis for the limited assurance provided by your review report.

Comparing the Financial Statements With Anticipated Results

4.604 These comparisons usually involve comparing significant absolute amounts in current period financial statement accounts with budgets or forecasts for those accounts. Of course, budgets or forecasts must be available and the accountant should consider whether they represent realistic objectives before deciding to make these comparisons.

Studying the Relationships of Financial Statement Elements That Would Be Expected to Conform to a Predictable Pattern Based on the Entity's Experience

4.605 As an example of this type of analytical procedure, the accountant may expect a change in sales to result in an accompanying change in accounts receivable and cost of sales, and changes in property and equipment to result in accompanying changes in depreciation expense and maintenance and repairs expense.

4.606 These relationships are often analyzed by computing ratios or performing reasonableness tests. Ratios depict the relationship between two financial statement amounts. Reasonableness tests use logical relationships between financial or nonfinancial data to estimate what a financial statement amount or change in such an amount should be. Before studying such relationships, the accountant should consider the potential effect on those relationships of the types of adjustments required in prior periods.

How to Select Analytical Procedures

4.607 The three categories of analytical procedures summarized above are only suggested by SSARS No. 1. The accountant may perform others, such as making comparisons to industry data. Furthermore, SSARS No. 1 does not set forth specific analytical procedures that accountants must perform. Accountants should choose the analytical procedures best suited for reviewing a particular client's financial statements by considering the following factors:

- The specific financial statement assertion to be addressed — existence; completeness; valuation; rights and obligations; or presentation and disclosure.
- The accounts that required adjustments in prior periods (likelihood of misstatement).
- The materiality of the account.

- Prior experience in choosing and applying analytical procedures for a specific client.
- The extent to which a particular item is affected by management's judgment.
- Availability and usefulness of industry statistics.

Practice Tip:

Don't apply analytical procedures mechanically. Identify the analytical procedure that best addresses the relevant financial statement assertion. Comparing amounts over time, calculating trends and ratios, and performing reasonableness tests for the same account is usually too much analytical review. In addition, if an account is not material or the likelihood of misstatement is low, the accountant may not need to apply any analytical procedures to that account.

Practice Tip:

For some engagements, for example, those involving new companies, there is a limited amount of comparable data to perform analytical procedures. In these situations the accountant can always study expected relationships within the current period. In addition, the accountant can always make more inquiries and use scanning of accounting ledgers and journals for unusual items to provide evidence. Also, don't ignore the evidence that is obtained from preparing any accounting schedules that may be necessary to compile the client's financial statements.

Unusual or Unexpected Results

4.608 Before performing analytical procedures, the accountant should determine the extent of changes in amounts, percentages, or relationships that he or she would consider significant. In making this determination the accountant should consider the following factors:

- *The extent of changes occurring in prior periods.* Some change is likely to be expected based on changed conditions or circumstances.
- *Financial statement materiality.* Changes should be evaluated in light of the materiality judgment the accountant is using for the financial statements taken as a whole.
- *The nature of the relationship.* Some analytical procedures are based on direct, straightforward relationships involving few variables. Other analytical procedures use indirect relationships or involve a number of different variables. Changes identified by direct-relationship analytical procedures are usually more accurate. Therefore, the accountant would be more likely concerned about smaller changes from these types of analytical procedures than from the indirect-relationship procedures.

4.700 SPECIAL SSARS ENGAGEMENTS

Financial Statements Prepared On An Other Comprehensive Basis of Accounting

4.701 Applicability of SSARS. An accountant may be engaged to compile or review the financial statements of an entity that prepares its statements on some other comprehensive basis of accounting (OCBOA). This possibility is specifically recognized in SSARS, as indicated by the following definition of a financial statement that is contained in SSARS No. 1:

> A presentation of financial data, including accompanying notes, derived from accounting records and intended to communicate an entity's economic resources or obligations at a point in time, or the changes therein for a period of time, in accordance with generally accepted accounting principles or a comprehensive basis of accounting other than generally accepted accounting principles.

Therefore, if an accountant "submits" an OCBOA financial statement to his or her client or others, the accountant should comply with the requirements of SSARS—the accountant must at a minimum compile the financial statements. Sample OCBOA compilation and review reports are presented in Chapter 20, section 20.803.

4.702 The Income Tax Basis of Accounting. The income tax basis of accounting involves preparing financial statements based on the methods and principles that are used by the client to file its income tax return. Entities that typically use the income tax basis of accounting include small businesses for which conversion to GAAP is costly, and partnerships for which income tax basis financial statements provide the most useful information to the financial statement users.

4.703 The Cash Basis of Accounting. The cash basis of accounting consists of recording transactions on the basis of cash receipts and disbursements. Using this method of accounting, certain revenues are recognized when the cash is received rather than when the revenues are earned, and certain expenses are recognized when they are paid rather than when the obligations are incurred. Entities typically use the cash basis of accounting when conversion to GAAP is costly.

Practice Tip:

An entity for which conversion to GAAP is too costly should probably use the income tax basis of accounting as opposed to the cash basis of accounting, if the entity files an income tax return.

4.704 The cash basis is usually accompanied by certain modifications that have substantial support. Ordinarily, a modification has substantial support if the method is equivalent to GAAP and if use of the method is not illogical. For example, it would be illogical to record revenue on the accrual basis and expenses on the cash basis. Modifications that have substantial support include capitalizing fixed assets, recognizing debt arising from cash transactions, recording depreciation on fixed assets, and accruing income taxes on cash basis income. When accompanied by these modifications the basis of accounting is often described as the modified cash basis.

4.705 Titles of OCBOA Financial Statements. The titles of OCBOA financial statements are important. Although limited examples of appropriate titles are given, paragraph 7 of SAS No. 62 (AU 623.07) makes it clear that OCBOA financial statements should be appropriately titled so as not to imply that they are GAAP-basis financial statements. In one example, SAS No. 62 states that "cash basis financial statements might be titled *statement of assets and liabilities arising from cash transactions*, or *statement of revenue collected and expenses paid.*" In addition, the literature is silent as to appropriate captions within the financial statements. Page 19 of the AICPA's "Preparing and Reporting on Cash- and Tax-Basis Financial Statements," (Product No. 006700) indicates that a review of submitted financial statements revealed that GAAP-basis financial statement captions are commonly presented in OCBOA financial statements.

4.706 Statement of Cash Flows. When a set of financial statements purport to present financial position and results of operations in accordance with GAAP, SFAS No. 95, *Statement of Cash Flows*, requires presentation of a statement of cash flows. According to AICPA Technical Practice Aid 1300.10, it is understood that the phrase "financial position and results of operations" refers to a GAAP presentation. Because OCBOA financial statements do not purport to present financial position and results of operations, presentation of a statement of cash flows for tax or cash basis financial statements is optional.

4.707 Disclosures. Disclosures in OCBOA financial statements are similar to those contained in GAAP financial statements. Footnote 4 of SSARS No. 1 states that SAS No. 62, *Special Reports* (AU 623), provides disclosure guidance for OCBOA financial statements. SAS No. 62 allows for considerable judgment in the nature and extent of OCBOA financial statement disclosures; however, it provides the following guidelines:

- OCBOA financial statements should include a **summary of significant accounting policies** that discusses the basis of presentation and describes how that basis differs from GAAP.
- If OCBOA financial statements include items that are the same as or similar to those in GAAP statements, **similar informative disclosures** are appropriate.
- Matters that are **not specifically identified on the face of the financial statements** should be considered for disclosure. These items include: related party transactions, restrictions on assets and owners' equity, subsequent events, and uncertainties.

Financial Statements Included in Prescribed Forms

4.708 Special Provisions for Prescribed Forms. Various bodies may design or adopt standard preprinted forms that require specific financial information about another entity. Banks, credit agencies, industry trade associations, and governmental and regulatory agencies are common examples of bodies that use such forms. Because these forms are designed to meet the specific requirements of the bodies using them, they often call for departures from GAAP. Such departures may pertain to measurement principles not in conformity with GAAP, such as using appraised value instead of cost. These departures may also pertain to the failure to request disclosures required by GAAP, such as not requiring disclosure of commitments or contingencies.

4.709 Under the reporting requirements in SSARS No. 1, GAAP or OCBOA departures must be disclosed in the accountant's compilation report. However, SSARS No. 3, *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (AR 300), provides an alternative form of compilation report on financial statements included in prescribed forms. The essence of this provision is elimination of the requirement to describe GAAP departures in the accountant's compilation report *for those departures required by the prescribed form.* The rationale underlying this provision is the presumption that the information required by a prescribed form is sufficient to meet the needs of the body that designed or adopted the form and that there is no need for the accountant to advise that body of GAAP departures required by the form.

4.710 The alternative report allowed by SSARS No. 3 is an option. The accountant may always elect to follow the reporting requirements in SSARS No. 1 and disclose all GAAP departures, including those called for by the prescribed form.

4.711 The reporting alternative for prescribed forms is available only for a compilation service. There is no provision for an alternative review report. If financial statements in a prescribed form are reviewed, all material GAAP departures, including those called for by the form, must be disclosed in the accountant's review report.

4.712 A standard prescribed-form compilation report is presented in Chapter 20, section 20.806.

4.713 An accountant may be asked to report on a separate presentation of specified elements, accounts, or items of a financial statement. Examples of such information include a schedule of net sales, a schedule of inventories, a schedule of accounts receivable, and a schedule of general and administrative expenses.

Compilations of Elements, Accounts, or Items of a Financial Statement

4.714 SSARS No. 1 provides guidance for the compilation and review of complete financial statements; not for specified elements, accounts, or items of a financial statement. Therefore, the accountant is not required to report on specified elements, accounts, or items, even when the accountant prepares and submits such presentations to a client or a third party. That is, the presentation of specified elements, accounts, or items of a financial statement may be conveyed (1) without any report, (2) with a simple transmittal letter, or (3) with a report that is descriptive of the accountant's services.

4.715 If the accountant decides to issue a report on the compilation of specified elements, accounts, or items of a financial statement, the authors suggest that the accountant comply with the performance standards contained in SSARS, and model the report after the compilation report on financial statements contained in SSARS No. 1. However, the reference to standards established by the American Institute of Certified Public Accountants should be omitted, because there are no standards that apply to the compilation of such information. (See Chapter 20, section 20.804 for an illustration of a compilation report on specified elements, accounts, or items of a financial statement.)

Presentation Prescribed in a Contractual Agreement That Is Not in Conformity With GAAP or OCBOA

4.716 Another type of special-purpose presentation is one that is prepared in conformity with a basis of accounting prescribed in a contractual agreement that results in a presentation that is not in conformity with GAAP or OCBOA. For example, an acquisition agreement may require an entity to prepare financial statements in which certain assets, such as inventories and properties, are presented in conformity with a valuation basis that is neither GAAP nor OCBOA. Another example is a loan agreement that requires the borrower to prepare financial statements in which inventories are presented based on their net realizable value.

4.717 Interpretation No. 18 to SSARS No. 1, *Special-Purpose Financial Presentations to Comply With Contractual Agreements or Regulatory Provisions*, states that special-purpose presentations prepared in conformity with a basis of accounting that is not GAAP or OCBOA should—

- Include disclosure of the basis of presentation in the notes to the financial statements.
- Contain similar informative disclosures when the presentation contains items that are the same as, or similar to, those contained in GAAP or OCBOA financial statements.
- Include titles that avoid any implication that the special-purpose financial statements are intended to present financial position, results of operations, or cash flows.

4.718 Interpretation No. 18 also establishes reporting guidance for accountants who compile or review special-purpose financial presentations that are not in conformity with GAAP or OCBOA. The interpretation requires that the accountant's compilation or review report on such presentations be expanded to include two explanatory paragraphs that contain the following information:

First Additional Paragraph

- An explanation of what the presentation is intended to present, a reference to a note to the financial statements that describes the basis of presentation, and an explanation that the presentation is not intended to be a presentation in conformity with generally accepted accounting principles. In a compilation engagement in which the entity chooses to omit substantially all of the disclosures and does not disclose in the financial statements the basis of presentation, the accountant should disclose the basis in the compilation report.
- A description of any significant interpretations made by management of the contractual agreement.

Second Additional Paragraph

- A statement that the distribution of the report is restricted to those within the entity, to parties to the contract or agreement, or to those with whom the entity is negotiating directly.

4.719 In a review engagement, one additional report modification is necessary. The standard review report includes a statement that the accountant is not aware of any material modifications that should be made to the financial statements for them to be in conformity with GAAP. Therefore, if the special-purpose presentation is not intended to be in conformity with GAAP, the accountant should modify the standard review report to refer to the basis of accounting prescribed by the contractual agreement.

4.720 In either a compilation or review engagement, if the accountant becomes aware of material departures from the basis of presentation described, the accountant should consider whether modification of his or her report is adequate to disclose such a departure.

4.721 Sample compilation and review reports are presented in Chapter 20.

Financial Statements Used in Conjunction With Management Consulting Services

4.722 In performing management consulting services, an accountant may become involved with the historical financial statements of an entity. For example, a consulting service might involve the preparation of financial statements for a company, division, or business segment, or the modification of financial statements prepared by the client. Alternatively, a consulting package prepared by the accountant may include financial statements that are compiled or reviewed by another accountant or that are client-prepared.

4.723 Financial statements submitted in a consulting package are not exempt from the requirements of SSARS. Therefore, if the presentation meets the definition of a financial statement and was generated or modified materially by the consultant, the requirements of SSARS must be followed. The consultant must at a minimum compile the financial statements and issue a compilation report.

4.724 When a consulting package includes financial statements that were compiled or reviewed by another accountant, and the other accountant's report is **not** included in the package, the consultant's report should include a reference to the other accountant's report that includes:

a. A statement that the financial statements included in the package were compiled or reviewed by another accountant. (The accountant's name should not be mentioned.)

b. The date of the other accountant's report.

c. A description of the standard compilation disclaimer or, for a review, the limited assurance included in the report.

d. A description or quotation of any modifications of the standard report or of any paragraph emphasizing a matter regarding the financial statements.

4.725 The following sample paragraph should be added to the consultant's report when a standard compilation report was issued by the other accountant on the financial statements included in the consulting package:

> The 19X4 financial statements of XYZ Company were compiled by other accountants whose report dated February 1, 19X5, stated that they did not express an opinion or other form of assurance on those statements.

4.726 The following sample paragraph should be added to the consultant's report when a standard review report was issued by the other accountant on the financial statements included in the consulting package:

> The 19X4 financial statements of XYZ Company were reviewed by other accountants whose report dated February 1, 19X5, stated that they were not aware of any material modifications that should be made to those statements in order for them to be in conformity with generally accepted accounting principles.

4.727 If a consulting package includes financial statements compiled or reviewed by another accountant and a copy of that accountant's report, the consultant need not mention the financial statements in his or her report.

4.728 When the consulting package includes financial statements that are client prepared, the financial statements should be accompanied by an indication that the accountant has not compiled or reviewed the financial statements and that he or she assumes no responsibility for them. This may be communicated as a note to the financial statements or in the consultant's report.

4.729 A consulting package may also include prospective financial statements. Because the package would normally be prepared for internal use only, the accountant may perform any form of services on the statements and should prepare a report that is addressed to the responsible party and:

a. Identifies the prospective information and describes what it is intended to present.

b. Describes the nature of the service and degree of responsibility taken with respect to the statements.

c. States the prospective results may not be achieved.

d. Discloses the distribution restriction of the statements and report.

e. Describes any limitations on the usefulness of the statements.

4.800 LISTING OF SSARS PRONOUNCEMENTS

4.801 Table 4-1 lists the SSARS pronouncements. The full text of the SSARS pronouncements and related Interpretations are in the AICPA *Professional Standards*, Volume 2 (Product No. 005014), and in the AICPA's *Codification of Statements on Standards for Accounting and Review Services* (Product No. 057166). Practice aids in the form of questions and answers on compilation and review matters written by the AICPA Technical Information Division Staff are included in the AICPA Technical Practice Aids (Product No. 005054).

Practice Tip:

On August 4, 1995, the AICPA Accounting and Review Services Committee approved the issuance of an exposure draft of a new SSARS that would provide an exemption from SSARS No. 1 for the assembly of financial statements for internal use only. The new SSARS would require an engagement letter, however, neither an accountant's report nor a legend on the financial statements would be required. This proposed amendment would not preclude an accountant from complying with SSARS No. 1 when he or she submits internal use only financial statements. To obtain the most recent information about this exposure draft, call the AICPA's Technical Information Hotline at 800-862-4272, menu option no. 2.

TABLE 4-1

Statements on Standards For Accounting and Review Services (SSARS)

No. 1 *Compilation and Review of Financial Statements* (December, 1978)

No. 2 *Reporting on Comparative Financial Statements* (October, 1979)

No. 3 *Compilation Reports on Financial Statements Included in Certain Prescribed Forms* (December, 1981)

No. 4 *Communication Between Predecessor and Successor Accountants* (December, 1981)

No. 5 (Rescinded by SSARS No. 7)

No. 6 *Reporting on Personal Financial Statements Included in Written Personal Financial Plans* (September, 1986)

No. 7 *Omnibus Statement on Accounting and Review Services—1992* (November, 1992)

Practice Tip:

In addition to the seven Statements on Standards for Accounting and Review Services (SSARS) listed above, over 20 interpretations of these pronouncements have been issued. These should be consulted when dealing with such issues as litigation services, draft financial statements, special purpose financial presentations, etc. These Interpretations are published in the AICPA's loose-leaf service, *Professional Standards*, Vol. 2 and are reproduced in the AICPA's IPS *Compilation and Review Manual*, Appendix A.

4.900 DOCUMENTATION

4.901 Illustrative forms and checklists for compilation and review engagements include Engagement Letter — Compilation (section 13.025); Form for Documenting Understanding of Client's Business and Industry — Compilation and Review Engagements (section 10.901); Form for Documenting Understanding of Client's Business and Industry — Supplement for Review Engagements (section 10.902); Compilation Engagement Work Program (section 10.903); Engagement Letter — Review (section 13.026); Review Engagement Work Program (section 10.904); Review Engagement Analytical Procedures Checklist (section 10.905); Review Engagement Checklist (section 10.906), and Representation Letter — Review Engagements (section 13.033).

CHAPTER 5

EVIDENCE ACCUMULATION

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EVIDENCE ACCUMULATION

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EVIDENCE ACCUMULATION

5.000 METHODS OF OBTAINING EVIDENCE

5.001 The third standard of field work of the AICPA's generally accepted auditing standards (GAAS) states:

> Sufficient, competent, evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

5.002 This chapter discusses certain procedures for gathering evidence in an engagement, including the confirmation process for audits, and the review of interim financial information. This chapter also includes a discussion of certain financial statement accounts that may include engaging a specialist as part of the evidence accumulation process, such as for auditing pension and other employee benefit costs.

5.003 Evidence-gathering procedures include the following:

- Physical examination
- Confirmation
- Observation
- Inquiries of the client
- Checking mathematical accuracy
- Performing analytical procedures

5.004 The audit programs in this Manual have been designed to include procedures that are:

- Relevant in the circumstances
- Based on information that is normally available
- Coordinated with the desired degree of reliability of the evidence
- Determined to be the most cost-beneficial

5.005 The standard program procedures will be supplemented by the in-charge's sample size selections, and by modification of the nature and timing of the procedures. Sample size selections will be guided by SAS No. 39, *Audit Sampling* (AU 350). The nature of accounts receivable confirmation procedures would include the choice between negative and positive confirmation requests in accordance with the provisions of SAS No. 67, *The Confirmation Process* (AU 330). (See section 5.200.) As an example of timing modifications, the in-charge may decide to change the timing of accounts receivable confirmations from December 31 to October 31 for calendar year-end clients.

5.100 TYPES OF EVIDENCE

5.101 There are normally three basic types of evidence:

- Internally generated
- Externally generated
- Auditor generated

5.102 Internally generated evidence is obtained from the client's books, records, and personnel. It is usually the least conclusive of the evidence types. The amount of internally generated evidence necessary to support a conclusion is generally more extensive than for the other evidence types. Such evidence may also be combined with other tests to reach a conclusion. For example, a conclusion that sales were properly recorded will require testing a number of invoices (internally generated evidence), as well as third-party confirmations (externally generated evidence) and possibly analytical procedures (auditor-generated evidence).

5.103 Externally generated evidence, such as independent third-party confirmations and vendor invoices, is usually more reliable than internally generated evidence. The reliability of such evidence, however, depends on the independent sample selection process and on control of the procedures being performed. For example, accounts receivable selections for confirmations must be based on our criteria applied to the entire population. The procedures also must be controlled by the auditor from the time the selection is made until the confirmations are mailed. Vendor invoices, while filed internally, originate from external sources and generally are more reliable than an internally generated sales invoice.

5.104 Auditor-generated evidence such as physical examination, observation, and checks of mathematical accuracy, are often the most conclusive types of evidence: Applied properly, these procedures often produce the maximum benefits for the costs incurred.

5.200 CONFIRMATION PROCEDURES

The Confirmation Process

5.201 SAS No. 67, *The Confirmation Process* (AU 330), discusses issues such as considering the relationship of confirmation procedures to the assessment of audit risk, designing appropriate confirmation requests, performing alternative procedures for nonresponses, and evaluating the results of the confirmation procedures. It also provides specific guidance for confirming accounts receivable.

Audit Risk

5.202 The auditor's assessment of audit risk directly affects the nature, timing, and extent of auditing procedures. As the audit risk level increases, the auditor must design more reliable substantive tests. Because third-party confirmations usually provide higher-quality audit evidence than is available from internal documents, the auditor might decide to perform confirmation procedures to reduce audit risk to an acceptably low level.

Designing the Confirmation Request

5.203 Confirmation requests should be carefully designed to ensure that the information confirmed is appropriate for the financial statement assertion being addressed. For example, a cash balance confirmation generally addresses the existence assertion, but not the completeness assertion because it does not provide any evidence that all cash accounts are recorded. SAS No. 67 also recommends that the auditor consider these other factors:

Form of confirmation. Confirmation forms are either positive or negative. Positive confirmations (which may be filled in or blank) are usually more costly, but are more effective than negative confirmations. Negative confirmations may be used as a substantive procedure only when the level of audit risk is low, there is a large number of small balances, and the auditor has no reason to believe that the recipients will disregard the confirmation requests.

- *Prior experience on the audit or on similar engagements.* Information from prior audits or similar engagements, such as poor response rates, misstatements, and inaccurate information on the prior year's confirmation requests, might cause the auditor to conclude that other auditing procedures would be more effective and efficient.
- *Nature of the information being confirmed.* The auditor should ask for confirmation of amounts or information that respondents will be readily able to confirm.
- *Person to whom the confirmation request is directed.* The confirmation should be addressed to a person who is knowledgeable about the information being confirmed. For example, confirmation of the balances and terms of debt agreements are often best addressed to the loan officer assigned to the client's account.

Performing the Confirmation Procedures

5.204 Most auditors are well aware of the need to control the mailing and receipt of confirmation requests. SAS No. 67 also suggests that auditors should follow-up with the respondent when they cannot verify the source of a confirmation reply, such as one received by facsimile. In such instances, the auditor should either call the respondent to verify the source of the reply or ask the respondent to mail the confirmation directly to the auditor.

5.205 For nonreplies to positive confirmations, SAS No. 67 requires that either the auditor perform alternative procedures, such as examining evidence of the subsequent collection of an account receivable, or treat nonresponses as errors, including projecting to the population if a sampling approach to the confirmation was used.

5.206 As a final step in the confirmation process, the auditor should consider the overall results of the confirmation procedures—whether the confirmations and alternative procedures were reliable, the nature of any exceptions, and evidence provided by other procedures. If the auditor concludes that these three factors do not provide sufficient evidence, he or she should consider requesting additional confirmations or performing other tests.

Accounts Receivable Confirmations

5.207 With the exception of accounts receivable, SAS No. 67 does not require auditors to perform confirmation procedures. SAS No. 67 requires that accounts receivable (including a financial institution's loans) be confirmed unless they are immaterial, their use would be ineffective, or the level of audit risk can be reduced to an acceptably low level through the use of other substantive procedures.

Uniform Commercial Code

5.208 When gathering audit evidence, Article 9 of the Uniform Commercial Code (UCC) (Secured Transactions) should be considered. This section covers consignments, leases, chattel mortgages, conditional sales contracts, trust receipts, fixture liens, and other security assignments. To determine that all such assignments have been recorded and/or disclosed in the financial statements, the UCC confirmation request form similar to the one in section 13.021 may be mailed to the Secretary of State in the states where the client does business. Each state will require its own form. Mailing a UCC confirmation should be considered on larger, more complex engagements, engagements with high risk, or engagements with <u>limited</u> internal control policies and procedures. Related security agreements or financing statement copies may be included in the permanent file. All collateral pledged and, if necessary for a meaningful presentation, the order of priority among creditors should be disclosed.

5.209 Article 2 of the UCC provides that goods on consignment are no longer the property of the consignor with respect to claims of the consignee's creditors unless the consignor's interest is evidenced by a sign, or the consignee is generally known to be selling goods for others, or the consignor files a financing statement under Article 9. When auditing consignees' records, the auditor needs to determine that purchases and sales are recorded in conformity with the consignment agreement terms. When auditing consignors, the auditor should determine that financing statements have been filed to protect the client's interests. Otherwise, it may be necessary to disclose the consignment status in the notes to the financial statements. Because these procedures involve legal matters, the engagement executive should consider reviewing the firm's conclusions with client's legal counsel.

5.210 Sample confirmation letters and forms are included in Chapter 13, sections 13.002–13.021.

5.300 AUDITING ACCOUNTING ESTIMATES

5.301 Accounting estimates in financial statements measure the effects of past business transactions or events, or the present status of an asset or liability. Net realizable values of inventory and accounts receivable, property and casualty insurance loss reserves, revenues from contracts accounted for by the percentage of completion method, and pension and warranty expenses are examples of accounting estimates.

5.302 Management is responsible for making the estimates; the auditor is responsible for evaluating their reasonableness. Management's process for making estimates should:

- Identify situations where estimates are needed.
- Identify the relevant factors that affect the estimates.
- Accumulate relevant, sufficient, and reliable data to make the estimate.
- Develop assumptions of the most likely circumstances and events with respect to the relevant factors.
- Determine the amount of the estimate and that it is in accordance with generally accepted accounting principles (GAAP).
- Consider using the work of a specialist regarding certain assumptions. (See section 5.350 below.)

5.303 The process used for making estimates should be discussed with management during planning.

5.304 The auditor, when evaluating reasonableness, should concentrate on key factors and assumptions and on understanding how the estimates were developed. One or a combination of the following approaches may be used:

- Review and test the process used by management to develop the estimate.
- Develop an independent expectation of the estimate.
- Review corroborating events or transactions occurring prior to completion of the field work.

Practice Tip:

Good internal control procedures may reduce the likelihood of material misstatements of accounting estimates. In evaluating accounting estimates, an auditor should consider, among other things, whether the estimates were prepared, review, and approved by qualified personnel and whether management communicated the need for proper accounting estimates.

5.305 The methods and results of the auditor's evaluation should be documented in working papers.

5.400 PENSION COSTS

5.401 SFAS No. 87, *Employers' Accounting for Pensions*, and SFAS No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits* (Section P16 in *Current Text*), cover pension plans in financial statements presented in accordance with GAAP that are written or unwritten, unfunded or funded, or are defined contribution or defined benefit plans.

Deferred compensation plans or deferred profit-sharing plans are also covered if the plan is, in substance, a pension plan.

5.402 Auditing procedures in the Tests of Balances Audit Programs (section 10.700) are designed to determine that the expense provision and the related assets and liabilities are recorded consistently in accordance with applicable pronouncements and that disclosures are adequate. The requirements of the applicable pronouncements, however, should be reviewed in detail before beginning audit procedures.

5.403 Although pension costs are usually determined by an actuary, the auditor cannot rely entirely on his or her judgment that computations have been made in accordance with applicable pronouncements.

5.404 An illustrative actuary's confirmation letter and a standard pension accounting working paper are included in Chapter 13, section 13.030 and Chapter 14, section 14.032.

5.500 POSTRETIREMENT BENEFITS OTHER THAN PENSIONS

5.501 SFAS No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, addresses the accounting treatment to be accorded postretirement benefits. Most companies currently account for retirement benefits on a "pay-as-you-go" basis, the same manner used to account for wages. This Statement requires an obligation for postretirement benefits to be recognized as the employee renders the services necessary to earn these benefits, regardless of when the benefits are received.

5.502 The provisions of this Statement are similar to those of SFAS Nos. 87 and 88.

5.503 SFAS No. 106 is generally effective for fiscal years beginning after December 15, 1992. The Financial Statements and Notes Checklist in Chapter 18, section 18.200 includes the required disclosures for this Statement.

5.504 The auditor should consider the actuary's competence, independence, and reputation as well as reviewing the applications of actuarial computations in the financial statements. The guidance in SAS No. 73 should be applied to actuaries. (See section 5.350.)

5.600 POSTEMPLOYMENT BENEFITS

5.601 SFAS No. 112, *Employers' Accounting for Postemployment Benefits*, establishes accounting guidance for benefits provided to former or inactive employees after employment but before retirement.

5.602 According to the Statement, a liability for employee's postemployment benefits should be accrued if all of the following conditions are met:

- The employer's obligation is attributable to employee's services already rendered,
- The obligation relates to rights that vest or accumulate,
- Payment of the benefits is probable, and

- The amount can be reasonably estimated.

5.700 REPRESENTATION LETTERS

5.701 Letters should be typed by clients on their letterhead using the illustrative forms in Chapter 13, section 13.032 for guidance. The letters should contain the date of the auditor's report.

5.800 OUTSIDE ASSISTANCE AND CONSULTATION ON ENGAGEMENTS

5.801 An important part of ensuring that firms provide high-quality engagements is encouraging staff to seek assistance when needed from the appropriate individuals. They should also be advised of the individuals within or outside the firm designated as specialists in relevant areas.

5.802 Chapter 8, section 8.300 discusses the requirements for consultation and presents examples of situations that may require consultation.

5.803 All consultations should be documented in a memorandum to the working papers or on a Consultation Form that includes a description of the issue, relevant authoritative literature, and the resolution. The memo or form should be signed by the individual who prepared it, the consultant or specialist (in the case of an in-house consultant or specialist), and the engagement executive. A Consultation Form is provided in Chapter 10, section 10.800.

5.900 RECENT AUTHORITATIVE PRONOUNCEMENTS

Fair Value and Derivatives Disclosures

5.901 This section includes descriptions of recently issued or proposed pronouncements with the widest applicability and relevance to small businesses. Recent pronouncements not considered relevant to most small businesses are not included herein.

5.902 SFAS No. 119, *Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments*, was issued to improve the financial reporting of derivatives. SFAS No. 119 is effective for calendar year 1994 financial statements, except for entities with less than $150 million in total assets, for which it is effective for calendar year 1995 financial statements. SFAS No. 119 expands and amends the requirements of SFAS No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk*, and 107, *Disclosures about Fair Value of Financial Instruments*. First, it expands the disclosure requirements of SFAS No. 105 to include additional types of derivatives, such as options held. It also amends SFAS No. 107 as follows:

- If fair value information is located in more than one note, a summary table of fair value information should be included.

- Fair value and carrying amount should be disclosed together.

- Disclosures should clearly designate whether the derivatives are assets or liabilities.
- Information should clearly relate to balance sheet line items.
- Fair value information should not be combined or netted with non-derivatives (except if netting is permitted under FIN No. 39).

5.903 The Statement requires the following additional disclosures:

For derivatives held or issued for trading purposes (generally applies only to financial institutions that deal in derivatives):

- The average fair value balance of positions during the reporting period and ending fair value, and the net gains or losses resulting from trading activities.
- Identification of the derivative from which the gains or losses arose, and where those amounts are reported in the income statement.

For derivatives held or issued for purposes other than trading:

- The objectives of holding or issuing the derivatives.
- Recognition and measurement policies.
- How they are reported in the financial statements (balance sheet and income statement locations).
- If the derivatives are used to hedge anticipated transactions, a description and time period for the transactions, the classes of the derivatives, deferred gains and losses, and the events that would cause gains and losses to be recognized.

5.904 Financial Statement presentation and disclosure requirements of SFAS No. 119 are included in the Financial Statement Disclosure Checklist in Chapter 18, section 18.200.

Impairment

5.905 SFAS No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*, was issued in March 1995 and is effective for financial statements for fiscal years beginning after December 15, 1995, with earlier application encouraged. Restatement of previously issued financial statements is prohibited. The Statement establishes accounting standards (including measurement and disclosure requirements) for the impairment of long-lived assets, certain identifiable intangibles, and goodwill related to those assets for assets to be held and used and assets to be disposed of. SFAS No. 121 amends several existing pronouncements (see paragraphs 20-33 of the Statement).

5.906 **Assets to Be Held and Used.** According to the Statement, an entity is required to review its long-lived assets, such as buildings and equipment, for impairment whenever events or changes in circumstances relating to the assets ("triggering events") indicate that the carrying amount of an asset may not be recoverable. In other words, an event or change in circumstances, such as a significant decrease in the market value of an asset, a significant change in the extent or manner in which an asset is used, or a significant physical change in an asset, may indicate that an asset has been impaired.

5.907 If a triggering event has occurred, the entity then determines if an impairment loss should be recognized by measuring the expected future cash flows[1] (undiscounted and without interest charges) to be generated from the use of the asset and its eventual disposition. If the sum of the expected future cash flows is less than the carrying amount of the asset, then an impairment loss should be recognized.

5.908 The amount of the impairment loss to be recognized is measured by calculating the difference between the carrying amount and the fair value of the asset. The fair value is defined as the amount at which the asset could be bought or sold in a current transaction between willing parties. If quoted market prices in active markets are not available, SFAS No.121 discusses various methods of determining the fair value of the assets, including using estimates of expected future cash flows discounted at a rate commensurate with the risks involved.

5.909 Once an impairment is recognized, the reduced carrying amount of the asset is the new cost basis that should be depreciated over the asset's remaining useful life. Restoration of previously recognized impairment losses is prohibited.

5.910 **Assets to Be Disposed Of.** If management has committed to a plan to dispose of long-lived assets (whether by sale or abandonment), has the authority to approve the action, and this action is not considered a disposal of a segment under APB Opinion No. 30, the assets should be reported at the lower of carrying amount or fair value, less costs to sell. Fair value is measured the same as for assets to be held and used. The costs to sell an asset includes incremental direct costs, such as broker commissions, legal and title transfer fees, and closing costs. Assets to be disposed of should not be depreciated while they are held for disposal.

5.911 Subsequent revisions to the estimates of fair value should be reported as adjustments to the carrying amount of the assets, not to exceed the carrying amount (original basis less accumulated depreciation or amortization) of the assets before the adjustment was made.

5.912 Financial statement presentation and disclosure requirements of SFAS No. 121 are included in the Financial Statement Disclosure Checklist in Chapter 18, section 18.200.

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[1] Future cash flows is defined as the future cash inflows expected to be generated by an asset less the future cash outflows expected to be necessary to obtain those inflows. When estimating expected future cash flows, assets should be grouped at the lowest level for which there are identifiable cash flows that are largely independent of the cash flows of other groups of assets.

Risks and Uncertainties

5.913 SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, was issued in December 1994 in response to a need for improved disclosure of significant risks and uncertainties brought about by a volatile business and economic environment. Many of the disclosure requirements of this SOP supplement or overlap the requirements of other authoritative pronouncements, primarily SFAS No. 5, *Accounting for Contingencies*. The SOP is effective for calendar year 1995 financial statements, and for interim periods in fiscal years subsequent to the year the SOP is first adopted. It applies to financial statements of all nongovernmental entities prepared in accordance with GAAP.

5.914 The disclosure requirements of SOP 94-6 fall into four categories:

All entities should report —

(1) Nature of operations

(2) Use of estimates in preparing financial statements

Only entities that meet certain conditions should report —

(3) Certain significant estimates

(4) Current vulnerability due to certain concentrations

5.915 Because the disclosure requirements of this SOP overlap with many other disclosure requirements, they may be combined or grouped with other related disclosures.

5.916 **Nature of Operations.** SOP 94-6 requires that an entity describe its major products or services and principal markets, including the location of those markets. If the entity operates more than one business, it should also disclose the relative importance of each business and the basis for determining the relative importance, such as assets, revenues, or earnings. It is not necessary to quantify the relative importance of different operations; instead, importance can be conveyed by terms such as "predominantly," "about equally," and "major."

5.917 Sample disclosures of nature of operations for a small business follows:

- Retail Franchisor of Sporting Goods

  Sporting Goods Headquarters, Inc. (the Company) was incorporated in Arizona in January 19X1. The Company operates retail sporting goods stores and grants franchises for the operation of retail sporting goods stores under the name of Sports Headquarters. At December 31, 19Y5, the Company had ten franchise locations and three company-owned stores.

- Manufacturing Company

  Pipe Co, Inc. located in Houston, Texas, manufactures tubing and related products. The Company sells primarily to manufacturers of oil field equipment and leisure products that are located in the Southwestern Unites States.

5.918 Use of Estimates in the Preparation of Financial Statements. Disclosures should include a statement that financial statements prepared in accordance with GAAP require the use of management's estimates. The following disclosure, found in paragraph A-9 of the SOP, can generally be used verbatim to satisfy this requirement:

> The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

5.919 Certain Significant Estimates. Disclosure of information about estimates is required if two criteria are met: (1) it is reasonably possible that an estimate about a condition existing at the balance-sheet date will change in the near term (one year from the balance-sheet date) and (2) the effect of the change would be material to the financial statements. Examples of estimates that are often sensitive to material change are:

* Inventory and specialized equipment subject to technological obsolescence
* Valuation allowances for deferred tax assets based on future taxable income
* Valuation allowances for commercial and real estate loans
* Environmental cleanup-related liabilities
* Litigation-related obligations
* Contingent liabilities for obligations of other entities
* Amounts reported for pensions and postemployment benefits
* Amounts reported for long-term contracts.

5.920 The disclosures for certain significant estimates supplement those in SFAS No. 5, *Accounting for Contingencies*. However, the SOP applies not just to estimates related to contingencies, but also to other types of estimates, such as those related to the carrying value of assets and liabilities (e.g., long-term construction contracts). Also, the SOP introduces the concept of a "near term" change in the estimate, while SFAS No. 5 makes no distinction between "near term" and long-term changes in estimates.

5.921 As mentioned above, this disclosure need only be made if two criteria are met:

1) *It is at least reasonably possible that an estimate about a condition that existed at the balance-sheet date will change in the near term.* The SOP draws on the SFAS No. 5 definition of reasonably possible, which is "more than remote but less than likely." Therefore, the likelihood that an estimate will change in the near term should be at least "more than remote." In considering whether the estimate is sensitive to change in the near term, the entity should consider only facts and circumstances known to management before the financial statements are issued.

   To illustrate, consider a construction contractor's long-term contracts. Estimated costs to complete includes a particular material, and management is aware at year-end that a shortage and resulting price increase for this material may occur in the next few months. If the likelihood of the price increase in the near term is more than remote, then this disclosure criterion is met.

2) *The effect of the change would be material to the financial statements.* Determining whether the effect of a change in estimate would be material to the financial statements is a matter of judgment, and presumably involves the same judgment used to determine whether other items are material to the financial statements. Also, note that the SOP refers to materiality in relation to the effect of the change, not to the estimate. For example, consider an entity that has not recorded a valuation allowance for inventory subject to rapid technological obsolescence. Even though no estimate is recorded, the entity might need to disclose the fact that it is reasonably possible that a material change in the estimate is likely to occur in the near term.

5.922 If an estimate meets the disclosure requirements of SOP 94-6, the following matters should be disclosed:

- The nature of the uncertainty and an indication that it is at least reasonably possible that a change in the estimate will occur in the near term.

- If the estimate involves a loss contingency covered by SFAS No. 5, an estimate of the possible loss or range of loss, or a statement that such an estimate cannot be made. (Note that this requirement overlaps with SFAS No. 5 disclosure requirements for loss contingencies. In fact, for such items, the only disclosure added by SOP 94-6 is the statement that it is at least reasonably possible that a change in the estimate will occur in the near term.) Also, the SOP recommends, but does not require, disclosing the factors that cause the estimate to be sensitive to material change.

5.923 Current Vulnerability Due to Certain Concentrations. The SOP requires disclosure of certain concentrations if: (1) the concentration exists at the balance-sheet date, (2) the concentration makes the entity vulnerable to the risk of a near-term severe impact, and (3) it is at least reasonably possible that the events that could cause the severe impact will occur in the near term. (As mentioned earlier near term is defined as a period not to exceed one year from the balance-sheet date.)

5.924 This disclosure is required only if all of the following criteria are met:

1. *The concentration existed at the balance-sheet date.* The SOP specifically identifies the types of concentrations that should be considered for this disclosure:

   - Concentrations in the volume of business transacted with a particular customer, supplier, or lender;
   - Concentrations in revenues from particular products or services;
   - Concentrations in the available sources of supplies of materials, labor or services (paragraph 24 of the SOP requires some specific disclosures for labor subject to collective bargaining agreements), or of licenses or other rights used in the entity's operations; and
   - Concentrations in the market or geographic area in which the entity operates (paragraph 24 of the SOP requires some specific disclosures for foreign operations).

2. *The concentration must make the entity vulnerable to the risk of a near-term severe impact.* The key concept (and probably the most difficult one) in applying this criterion is the concept of "severe impact." Paragraph 7 of the SOP defines severe impact as:

   A significant financially disruptive effect on the normal functioning of the entity. Severe impact is a higher threshold than material. Matters that are important enough to influence a user's decisions are deemed to be material, yet they may not be so significant as to disrupt the normal functioning of the entity...The concept of severe impact, however, includes matters that are less than catastrophic.

   As with materiality, determining whether something would constitute a severe impact requires judgment. For example, consider a manufacturer that buys all of its raw materials from one supplier. The loss of this supplier would cause significant production delays and greater than material losses of revenues, yet other suppliers can provide similar raw materials under similar terms. Thus, although losing this supplier could have a significant financially disruptive effect on the normal functioning of the entity, it would not cause bankruptcy because the entity could ultimately turn to other suppliers and resume normal operations.

3. *It is at least reasonably possible that the event that could cause the severe impact will occur in the near term.* As noted above, the SOP uses the SFAS No. 5 definition of reasonably possible of "more than remote but less than likely." Thus, the probability threshold for disclosure of a concentration is the same as that for disclosure of a loss contingency.

5.925 It is important to note that the SOP indicates that two types of concentrations are always considered to meet this "reasonably possible" criterion: (1) concentrations of customers, grantors, or contributors; and (2) concentrations of operations in foreign countries.

5.926 If any concentrations meet these criteria, paragraph 24 of the SOP states that disclosure "should include information that is adequate to inform users of the general nature of the risk associated with the concentration." An example of a disclosure for a concentration related to customers follows:

> At December 31, 19X5, receivables from three customers were about 45% of trade accounts receivable, and sales to these customers comprised 40% of total sales for the year then ended.

5.927 The Financial Statement Disclosure Checklist and Illustrative Financial Statements in Chapter 18, sections 18.200 and 18.500, have been updated to include the disclosure requirements for SOP 94-6.

5.928 **Audit Considerations for SOP 94-6.** Since entities must adopt SOP 94-6 for their December 31, 1995 financial statements, auditors of those entities will need to ensure that the client has disclosed the nature of its operations, the use of estimates in preparing financial statements, certain significant estimates, and certain concentrations. The first two disclosures should be fairly straightforward. In fact, many companies already disclose information about the nature of their operations. The more difficult challenge for auditors will be to determine if circumstances that trigger the other two disclosures -- certain significant estimates and current vulnerability due to certain concentrations -- exist and, if they do, whether the disclosures are appropriate.

5.929 Generally, much of the information auditors obtain during the normal course of the audit provides a good foundation for determining whether the client has estimates and concentrations that require disclosure. Specific procedures directed towards SOP 94-6 may include:

<u>Certain Significant Estimates:</u>

- Obtain or prepare a listing of any estimates used in determining the carrying values of assets and liabilities and gain and loss contingencies that are sensitive to change. Using information obtained in other audit areas and through inquiries of management, determine that the listing is complete and accurate.

  Examples of such estimates include:

  * inventory and specialized equipment subject to technological obsolescence
  * valuation allowances for deferred tax assets based on future taxable income
  * valuation allowances for commercial and real estate loans
  * environmental cleanup-related liabilities
  * litigation-related obligations
  * contingent liabilities for obligations of other entities
  * amounts reported for pensions and postemployment benefits
  * amounts reported for long-term contracts

- Consider whether it is at least reasonably possible that a material change in the estimate will occur in the near term.

- If such a situation is identified, review support for the calculation of the effect of the change.

Certain Concentrations

- Obtain or prepare a listing of the following types of concentrations, if any, that existed at the balance-sheet date and that make the entity vulnerable to risk of near-term severe impact (severe impact is a higher threshold than materiality, but less than catastrophic). Using information obtained in other audit areas and through inquiries of management, determine that the listing is complete and accurate:

  * volume of business transacted with a particular customer, supplier, or lender
  * revenues from particular products or services
  * available sources of supply of materials, labor or services, or of licenses or other rights used in operations
  * market or geographic area in which the entity conducts its operations

- Determine whether it is at least reasonably possible that an event will occur in the near term that would cause the severe impact.

5.930 The Tests of Balances Audit Program in Chapter 10, section 10.700, includes steps for considering the completeness and accuracy of the SOP 94-6 disclosures.

SOP 95-2, *Financial Reporting by Nonpublic Investment Partnerships*

5.931 On May 19, 1995, the AICPA's Accounting Standards Executive Committee issued SOP No. 95-2, *Financial Reporting by Nonpublic Investment Partnerships*. This SOP applies to financial statements of investment partnerships exempt from SEC registration under the Investment Company Act of 1940 (with certain exceptions) when such statements are prepared in conformity with GAAP.

5.932 The SOP provides guidance on financial statement presentation and disclosure of investments, income, and partners' capital, including requirements to:

- Include a condensed schedule of investments in securities,

- Present a statement of operations in conformity with the requirements for statements of operations of management investment companies in the Audit and Accounting Guide, *Audits of Investment Companies*, and

- Disclose in the notes the method of computing payments or allocations to the general partner for management fees and present the amounts of such payments in either the statement of operations or the statement of changes in partners' capital.

5.933 The SOP is effective for financial statements issued for fiscal years beginning after December 15, 1994. Earlier application is encouraged.

Practice Bulletin (PB) No. 14, ***Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships***

5.934 In April 1995, the AICPA's Accounting Standards Executive Committee issued Practice Bulletin (PB) No. 14, *Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships,* which requires that financial statements of a limited liability company (LLC) should:

- Be similar in presentation to those of a partnership,
- Be clearly identified as those of a limited liability company, and
- Disclose any limitations of members' liability, and different classes of members' interests and respective rights, preferences and privileges of each class.

5.935 The PB, which includes additional accounting, reporting, and disclosure requirements, is effective for financial statements issued after May 1995.

The Auditor's Consideration of Management's Adoption of Accounting Principles for New Transactions or Events

5.936 This interpretation establishes guidance on what the auditor should consider when determining the appropriateness of an accounting principle adopted by management for material new types of transactions or events for which there are no established sources of accounting principles. The Interpretation states that when the auditor is evaluating the principle, he or she should assess the appropriateness of management's basis for selecting the principle by considering whether there are:

- Analogous transactions or events for which there are established accounting principles, or
- Other accounting literature.

Auditing Interpretation, ***Audits of Financial Statements That Had Been Previously Audited by a Predecessor Auditor***

5.937 This interpretation of SAS No. 7, *Communication Between Predecessor and Successor Auditors,* was issued in April 1995. The Interpretation provides guidance to an auditor who is auditing and reporting on financial statements previously audited and reported on by a predecessor auditor (referred to as "reauditing"). The Interpretation states that:

- The auditor should request the predecessor auditor's workpapers for the year under audit and for the prior year.
- The review of these workpapers and inquiries of the predecessor auditor do not in themselves constitute sufficient competent evidential matter to provide a basis for expressing an opinion on the financial statements.
- The successor auditor should not divide responsibility for the work performed in his or her report.

- The successor may consider the information obtained from inquiries of the predecessor and any review of the predecessor's working papers and report in planning a reaudit.

- The successor auditor must become satisfied with the existence of beginning physical inventories by making or observing physical counts of inventories after the reaudit period and performing "roll back" procedures, test intervening transactions, such as testing prior transactions, reviewing prior count records, and performing analytical procedures. The auditor may not use the predecessor's inventory or other work for these purposes.

5.938 In April 1995, two Auditing Interpretations of SAS No. 70, *Reports on the Processing of Transactions by Service Organizations* were issued:

a. *Describing Tests of Operating Effectiveness and the Results of Such Tests,* (AU 9324.31-.03) provides guidance to a service auditor as to how much detail and what information should be included in the description of "tests applied" and the "results of the tests."

b. *Service Organizations that Use the Services of Other Service Organizations (Subservice Organizations)* (AU 9324.04-.18) provides guidance for the user auditor and the service auditor when the service organization uses a subservice organization.

5.939 Auditing Interpretation, *Reporting on a Special-Purpose Financial Statement that Results in an Incomplete Presentation But Is Otherwise in Conformity with Generally Accepted Accounting Principles* (AU 9326.80-.87), defines what constitutes a contractual agreement under AU 623, *Special Reports*, and which guidance within the standards should be followed under different "special reporting" situations. This Interpretation also provides guidance when the auditor is to distribute the report to additional parties that were not part of the original contract or agreement.

5.940 Auditing Interpretation, *Eliminating a Going-Concern Explanatory Paragraph From a Reissued Report* (AU 9341.01-.02) addresses the situation where auditors are asked to reissue reports that included a going-concern explanatory paragraph because the situation or condition that gave rise to substantial doubt about the entity's ability to continue as a going-concern has been resolved. This Interpretation provides guidance for auditors who agree to reissue their reports in such instances. It's important to note that the Interpretation does not *require* auditors to reissue their reports, however, if the auditor does agree to reissue his or her report, he or she should:

- Audit the event or transaction that prompted the request for reissuance,

- Perform procedures in paragraph 12 of AU 560, Subsequent Events, at or near the date of reissuance, and

- Consider factors described in paragraphs 6-11 of SAS No. 59, based on the conditions and circumstances at the date of issuance.

PROPOSED STATEMENTS

5.941 Amendment to SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit.*

In February 1995, the AICPA Auditing Standards Board issued a proposed amendment to SAS No. 55 that would incorporate the internal control concepts found in *Internal Control -- Integrated Framework Report* (often referred to as the "COSO report"). Specifically, the amendment would change the current definition of internal control in SAS No. 55 from "control environment, accounting system, and control procedures" to the definition in the COSO report, "control environment, risk assessment, control activities, information and communications, and monitoring." The AICPA Audit Guide, *Consideration of the Internal Control Structure in a Financial Statement Audit*, will also be revised simultaneously. The final documents are expected to be issued in December 1995; and are expected to be effective for audits of entities with fiscal years beginning January 1, 1997. This amendment is not expected to have a significant impact on practical applications of SAS No. 55.

5.942 A proposed amendment to SAS No. 58, *Reports on Audited Financial Statements,* was issued in July 1995 that would eliminate the requirement to add an explanatory paragraph to the auditor's report for certain uncertainties. This amendment would not affect the requirement in SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, to add such a paragraph for going-concern uncertainties. If approved, the final SAS is expected to be issued in December 1995, and would be effective for reports issued on or after June 30, 1996.

5.943 To determine the current status of these proposed amendments, call the AICPA's Technical Hotline at 800-862-4272, menu option 2.

5.944 In June 1995, the AICPA Accounting Standards Executive Committee issued a proposed Statement of *Position, Environmental Remediation Liabilities (Including Auditing Guidance),* which provides guidance on the recognition, measurement, display and disclosure of certain environmental remediation liabilities. Among other things, the SOP requires that environmental remediation liabilities be accrued when the criteria of SFAS No. 5 are met, and it includes benchmarks to aid in determining when such liabilities should be recognized in accordance with SFAS No. 5.

Among the costs to be included in the measurement of the liability are:

a. Incremental direct costs of the cleanup effort,

b. Costs of compensation and benefits for employees to the extent they will devote time directly to the cleanup effort, and

c. Certain costs of legal work related to the cleanup effort.

The proposed SOP would be effective for financial statements beginning after December 15, 1995.

Documentation

CHAPTER 6

DOCUMENTATION

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CHAPTER 6

DOCUMENTATION

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CHAPTER 6

DOCUMENTATION

6.000 BASIC REQUIREMENTS

6.001 Working papers should demonstrate the auditor's or accountant's compliance with professional standards and firm policy. This chapter presents some guidelines for preparing and organizing workpaper files. These guidelines should be adapted and modified to fit each firm's engagements and organizational structure. Adoption of uniform working paper requirements facilitates on-the-job training for new firm personnel and also helps expedite the engagement review process.

Specific Purposes of Working Papers

6.002 Working papers should be prepared to document the results of procedures performed and judgments made in designing tests to accomplish the objectives of an engagement. Each working paper should clearly document such procedures. Work performed should not be documented in the client's records.

6.003 Illustrative working papers are included in Chapter 14 for guidance. Applicable papers should be selected and modified based on the objectives and circumstances of each engagement.

Client-Prepared Working Papers

6.004 Whenever feasible, the client should be asked to prepare as many working paper schedules as possible. The illustrative working papers should be used for guidance. Copies of client's internal schedules may be used if practical. If feasible, some working paper schedules may be prepared using the client's computer system. If a client is not willing to prepare working paper schedules, or if a client's employees don't have the time or capabilities for preparing working paper schedules, firm paraprofessional or outside temporary help may be used to minimize costs.

6.005 All working paper schedules prepared by the client should be marked "PBC" ("prepared by client") in the upper right hand corner. All PBC schedules should be footed, agreed to the general ledger, and traced on a test basis to underlying documentation.

6.100 WORKING PAPER FILES CONTENTS

6.101 The following working paper files should be maintained as applicable to the nature of each engagement:

- Planning and Supervision File
- Current Engagement File
- Permanent File
- Tax File
- Correspondence File
- Time Budget and Control File
- Billing File

Planning and Supervision File

6.102 The following illustration includes the standard documentation that should be included in the Planning and Supervision File for full disclosure compilation (1), disclosures-omitted compilation (2), review, and auditing services:

ILLUSTRATION NO. 6-1

	Compilation 1	Compilation 2	Review	Audit
1. Client Acceptance and Continuance Form	X	X	X	X
2. Correspondence with Predecessor Accountants			X	X
3. Engagement Letter	X	X	X	X
4. Planning Matrix (ABC System only)				X
5. Summary of Possible Journal Entries			X	X
6. Materiality Computation Form				X
7. Compilation Engagement Work Program	X	X		
8. Review Engagement Work Program			X	

	Compilation 1	Compilation 2	Review	Audit
9. Checklist for Understanding Client and Industry	X	X	X	
10. Review Engagement Analytical Procedures Checklist			X	
11. Review Engagement Checklist			X	
12. Internal Control Flowcharts and Internal Controls Questionnaire or All-Substantive Approach Questionnaire				X
13. Risk of Potential Misstatements Evaluation Form (ABC System only)				X
14. Planning Memorandum				X
15. Sampling Decision Working Paper				X
16. Tests of Controls Program				X
17. Internal Control Structure Reportable Conditions Form				X
18. Analytical Procedures Program				X
19. Tests of Balances Audit Program				X
20. Consultation Form	X	X	X	X
21. Engagement Performance Review Checklist	X	X	X	X
22. Tax Accrual/Provision Checklist			X	X
23. Financial Statement Disclosure and Reporting Checklists	X		X	X

ILLUSTRATION NO. 6-1 (Continued)

	Compilation 1	Compilation 2	Review	Audit
24. Technical Review Checklist	X		X	X
25. Financial Statement Control Form	X	X	X	X
26. Operations and Management Related Matters Checklist (when required by partner)	X	X	X	X

Current Engagement File

6.103 All current working papers and related correspondence should be included. Depending on the size of the engagement, major sections may be filed separately.

6.104 In addition to a working trial balance, or a summary trial balance and lead sheets, special memoranda in judgmental areas such as inventory observation and allowance for doubtful accounts, and any outside correspondence, the current working paper files should contain at least the following:

ILLUSTRATION NO. 6-2

Reviews	Audits	
• Analysis of accounts customarily subjected to audit or review (major financial statements classifications).	X	X
• Analysis of material account balances.	X	X
• Analysis of accounts necessary to meet disclosure requirements.	X	X
• Analysis of accounts to meet tax return requirements.	X	X
• Analysis of accounts connected with any unusual matters encountered during the engagement.	X	X

Permanent File

6.105 The permanent file should contain information of continuing engagement significance, such as the following:

ILLUSTRATION NO. 6-3

A. Document

1. Articles of incorporation.
2. Corporate bylaws.
3. Sales contracts.
4. Patent agreements.
5. Purchase contracts.
6. Bonus, profit sharing plans, and employment agreements.
7. Partnership agreements.
8. Labor agreements.
9. Long-term debt agreements.
10. Sample bond certificates.
11. Lease agreements.
12. Stock permits.
13. Stock option and incentive plans.
14. Stock repurchase agreements.
15. Operating or management agreements.
16. Regulatory commission orders.

B. Continuing Analyses

1. Analytical procedures working paper.
2. Listing of depositories.
3. Inventories by product line.
4. LIFO data.
5. Long-term investments.
6. Depreciation lapse schedules.
7. Amortization schedule of deferred charges.
8. Features of long-term debt.
9. Test of compliance with debt covenants.
10. Summary of lease commitments.
11. Descriptions and analyses of capital stock.
12. Summary of capital stock reserved.
13. Schedule of stock options.
14. List of principal shareholders and their holdings (if the client is publicly held).
15. Record of capital stock book examination.
16. Additional paid-in capital.
17. Retained earnings.

C. Accounting Policies

1. Memoranda relating to important or continuing accounting problems.
2. Memoranda detailing firm positions on significant accounting treatments expressed to the client.
3. Organization data.
4. Accounting or procedures manual.
5. Chart of accounts.
6. Superseded internal control documentation.

The Permanent File may be indexed by using the outline designations above preceded by PF, e.g., PFB5 or PFC4.

Tax File

6.106 Where applicable, this file should contain:

1. Current and prior-year income tax returns.

2. A Tax Return Preparation Checklist.

3. Income tax working papers not included in the Current Engagement File.

4. A Tax Planning Checklist, tax working papers, or memos.

5. Tax Accrual/Provision Review Checklist, Chapter 12, section 12.204.

Correspondence File

6.107 Copies of all correspondence to and from the client, with the exception of engagement letters, should be included in the file, including representation letters, management letters, and completed reports.

Time Budget and Control File

6.108 This file should contain at least the following, as applicable, to all engagements in excess of 40 hours:

- Time Summary Form. (Chapter 11, section 11.200)
- Time Accumulation Sheet. (Chapter 11, section 11.201)
- Summary of Time Savings for Next Year. (Chapter 11, section 11.202)

Billing File

6.109 This file should include copies of client time summaries, client invoice preparation forms, billing adjustments forms including explanations of adjustments, and copies of client invoices.

6.200 WORKING PAPER PREPARATION

Compliance With Professional Standards

6.201 SAS No. 41, *Working Papers* (AU 339), establishes working paper requirements for audit engagements and provides general guidance for their preparation and use. The purposes of working papers, in addition to demonstrating that accounting records agree with financial statement amounts, include providing evidence to demonstrate:

1. The work has been adequately planned and supervised.

2. An understanding of the internal control structure has been obtained and used as a basis for assessing control risk and for deciding on the most appropriate audit approach in each client's circumstances.

3. The audit evidence obtained, auditing procedures applied, and testing performed provide sufficient, competent, evidential matter to support the level of assurance necessary for an opinion.

6.202 SSARS 1, *Compilation and Review of Financial Statements*, paragraph 30 (AR 100.31), requires certain working papers for reviews, but does not state specific working paper requirements for compilations. Rule 201(d) of the AICPA Code of Professional Conduct requires that evidence be obtained to afford a reasonable basis for conclusions in all types of services.

6.203 Considering this requirement, working paper schedules should normally be prepared on review engagements for all material balance sheet accounts and for income statement accounts considered during analytical procedures. Management's responses to the accountant's inquiries, the accountant's judgments and actions in respect of such responses, and a record of any corroborating evidence inspected during investigation of unusual matters should also be documented on working papers. The extent of the documentation will increase as the engagement risks increase.

6.204 While inquiries and analytical procedures are not required for compilations, accountants are required to "read" the financial statements for "obvious, material errors." Information should be gathered to support required financial statement disclosures, as well as to follow up on any obvious, material errors.

Accomplishing the Basic Purposes of Working Papers

6.205 Effective engagement planning, including involvement of the engagement partner, must occur and be documented well before the start of an engagement to achieve both quality and maximum profitability. Planning activities should be documented in the audit program, time budget and control files, working papers, and memoranda. In addition to matters of engagement administration, the four basic audit planning decisions should be presented in a planning memorandum for review by the engagement partner before engagement staff personnel begin field work.

6.206 The basic audit planning decisions and related documentation sources are:

1. Obtain an understanding of the client's internal control structure. For the ABC system, the Internal Controls Questionnaire in section 10.100 should be completed. For the All-Substantive Approach, the All-Substantive Approach Questionnaire in section 10.200 should be completed.

2. Determine the level of overall engagement risk, the risk of potential misstatements, and the overall materiality limit.

   Overall engagement risk should be a by-product of the client acceptance or retention decision. The Client Acceptance and Continuance Form (section 10.000) and related memoranda include an evaluation of the engagement risks resulting from the integrity of management, the planned uses of financial statements, the auditability of the entity, and the business environment.

   Audit risk assessment and documentation, i.e., inherent, control, and detection risk, may occur concurrently with obtaining an understanding of the internal control structure. Depending on the adequacy of the client's internal control structure and the efficiency with which tests of balances can be performed, two alternative sources of documentation are available: (1) Internal Control Questionnaire (section 10.100) and related narratives and/or flowcharts, and (2) All-Substantive Approach Questionnaire (section 10.200).

   The computations of materiality levels established during planning should be documented on a working paper or the Materiality Computation Form (section 10.600). Such documentation should include, at a minimum, the overall materiality limit computation and rationale and the computation of the lower limit for individually significant items. In addition to determining individually significant items to audit 100%, this lower limit can be used to determine when sampling populations are immaterial and not subject to SAS No. 39, and to determine immaterial account balances for which no work may be necessary.

3. Make judgments about the staffing of the engagement, the extent of supervision, and the degree of professional skepticism. The Audit Planning Memorandum in section 10.300 should be used to make those determinations.

4. Decide on the most cost-beneficial audit approach based on the risk assessment and materiality decisions. For the ABC System, use the Planning Matrix in Section 10.103. For the All-Substantive Approach, use the related questionnaire in Section 10.200.

6.207 Supervision and review documentation must be provided for all levels of engagement review. Such documentation may be included in working papers, in audit programs, in supervision and review checklists, or in special memoranda. Evidence of the supervision and review function will normally occur as follows:

Engagement In-charge: The in-charge should meet with engagement personnel before the field work begins to explain the audit approach, individual responsibilities, and the modified audit program to each staff person. This meeting can be documented by signing a program step and by preparing a working paper or memorandum. All working papers prepared by assistants should be reviewed by the in-charge and all review notes cleared by the staff person. The in-charge should initial and date all workpapers reviewed. All such review notes should be destroyed when finally cleared. The in-charge should complete the Engagement Performance Review Checklist (section 12.411) upon completion of the engagement.

Engagement Partner: The partner should review and sign the Planning Memorandum before the field work begins. The partner should review all working papers prepared by the in-charge and any other working papers not reviewed by the in-charge. Whenever the partner reviews a working paper, whether or not reviewed by the in-charge, the review should be documented by initialling and dating the working paper. The partner should sign all supervision, review, and disclosure checklists.

Documenting the Understanding of the Internal Control Structure

6.208 The documentation of the understanding of the internal control structure, as described in section 6.206, will follow the selection of the most cost-beneficial audit approach. The documentation will consist of questionnaires or forms, narratives and/or flowcharts. Obtaining an understanding of an entity's internal control structure must be documented on all audit engagements. Such documentation may be the basis for controls testing and reductions in substantive tests *or* it may be a means for identifying risks of potential misstatements that will require modification of substantive tests. At a minimum, it will document engagement personnel's understanding of the control environment, the accounting system, and control procedures.

Collecting Sufficient and Competent Evidential Matter

6.209 For many years, sufficient, competent evidential matter was thought of primarily as the *results* of auditing procedures. As a result of SAS No. 41 and subsequent pronouncements, it is clear such evidential matter must consist of documentation of *all* rationale and judgments applied during engagement decision-making in addition to the results of performing auditing procedures.

Practice Tip:

Peer reviews continue to identify deficiencies in working papers. In some cases, reviewers have noted an absence of working papers or inappropriate or incomplete working paper content. The authors emphasize that auditors should ensure that working papers are *sufficient* to show that the accounting records agree or reconcile with the financial statements or other information being reported on *and* that the standards of field work are being observed.

Practice Tip:

A successor auditor must obtain sufficient competent evidential matter as a basis for expressing an opinion. This includes reviewing the predecessor auditor's working papers concerning opening balances, consistency in the application of accounting principles, and contingencies. If the working papers of a predecessor who ceased operations are not available, the evidence normally obtained by reviewing the working papers must be obtained by performing other audit procedures. If sufficient competent evidential matter cannot be obtained through other procedures, the auditor should qualify or disclaim an opinion.

6.300 SOME BASIC PREPARATION RULES

1. The following are some basic mechanics of working paper preparation:

   a. All working papers must include the initials of the staff person principally responsible for the work evidenced on the paper. All working papers must bear the initials of at least one reviewer, even if the working paper is prepared by a partner. The date of performance should accompany both initials. If prepared by the client, the working papers should be marked "PBC".

   b. All working papers should contain headings that include the client's full legal name, the financial statement date, and a *specific* description of the contents of the working paper.

   c. All working papers should be indexed and cross-referenced to the trial balance. Specific information should be cross-referenced to related amounts or information elsewhere in the working papers. Audit program procedures should also be cross-referenced to applicable working papers. Not only does cross-referencing provide a trail for more efficient reviews, it serves as a double-check on the accuracy of preparation.

   d. All tickmarks should be adequately explained and, whenever practical, standard tickmarks should be used. Adequate explanations include a description of the procedure (what we did), its results (what we found) and why such results are acceptable or unacceptable (what we did about what we found). Explanations of tickmarks by outstanding checks on a bank reconciliation like "Traced to cutoff bank statement" are incomplete. Stating, in addition, "By examining the dates of paid checks, I determined that all checks were properly included in the reconciliation as outstanding at 12/31/19X" will provide proper documentation for the work performed.

      When standard tickmarks are used, each working paper file should contain a tickmark legend. Common standard tickmarks include:

      F Footed

      CF Crossfooted

G/L Traced to general ledger

C Confirmed

✓ Calculation verified

T/B Traced to the trial balance

V Vouched to supporting documents

Explanations of standard tickmarks should also describe what was done, what was found, and what was done about the findings unless the action taken is obvious. For example, the tickmark "C" is often used to indicate an account receivable or cash balance has been confirmed; often staff persons fail to explain whether or not exceptions resulted from the process.

e. Write legibly, clearly, and concisely and leave adequate space between lines, accounts, entries, computations, etc. Use adequate sizes and quantities of working paper.

f. After the working paper has been prepared, set it aside for a short period of time. Before submitting it to the in-charge or partner, perform a self-review for compliance with the items outlined in a. through e. above.

2. The sources of all working paper information and evidence of procedures performed should be clearly and specifically documented. For example, the source for receiving reports used in a payments and acquisitions cycle test of controls for completeness should be documented. As another example, documentation should be made of check numbers or entries in a cash disbursements journal selected for the search for unrecorded liabilities.

   Comments like "per client" or "inspected all subsequent disbursements over $500," or other inadequate or missing references to the source of information, do not provide an adequate formal record that can be used to prove that the work was actually done. Unfortunately, the auditor's testimony that certain work was performed, or that certain sources of information were inspected, may not be sufficient evidence in a court of law. In addition to the possible damage to a firm's reputation that could arise in litigation, such poor working paper preparation techniques can cause succeeding years' staff to waste considerable time relocating the sources of information and understanding the prior year's work.

Using Audit Memoranda

6.301 The most common uses of audit memoranda are to document—

- engagement planning activities,
- the results of tests of controls and their effects on tests of balances,
- inventory observations,
- the analysis of the adequacy of the allowance for doubtful accounts,

- the evaluation of going-concern problems,
- the risks of misstatements and their effect on evidence accumulation,
- all the facts leading to decisions on the "tough calls", including explanations of why certain factors were considered more persuasive in reaching conclusions,
- consultations, and
- matters concerning contingencies and inconsistencies.

6.302 Memos should normally be written to provide evidence that is not provided elsewhere in the engagement documentation. The following is a standard format for preparation of memos:

- Describe the problem or situation for which the memo is being prepared.
- Describe the nature of the work performed and the evidence collected.
- Describe the results of the work performed.
- Describe the effects of the work performed on our engagement evidence, financial statement disclosures, or accountants' or auditors' report.

Working Paper Conclusions

6.303 For audit engagements, the in-charge has the primary responsibility for drawing conclusions. These conclusions will be documented by the in-charge and engagement partner while completing the Engagement Performance Review Checklist (section 12.411). Working paper conclusions are not recommended for audit engagements. Should working paper conclusions be prepared, however, they should:

- Be written in the first person and signed on the area's lead sheet or first working paper.
- Be stated in terms of the area's audit objectives.
- Be justified by the work performed or reviewed by the person making the conclusion.

6.304 For compilation and review engagements, working paper conclusions should not be made. The in-charge and the engagement partner will reach overall conclusions when completing the applicable checklists (section 10.900).

6.400 ENGAGEMENT DOCUMENTATION PACKAGES

6.401 Standard programs, checklists, documents, working papers, and correspondence forms have been included in Volumes 2 and 3 of this Manual. Engagement supplies have been organized to facilitate their selection and use as follows:

1. Illustrative working papers are filed separately.

2. The Tests of Controls Program (Chapter 10, section 10.400) is organized by type of internal control system (System A, B and C). After the engagement partner's review of applicable sections of the Planning Matrix (Chapter 10, section 10.103), the in-charge should select and modify the appropriate programs.

3. Other forms and checklists supplies have been filed by engagement areas as considered necessary.

Completing the Engagement

CHAPTER 7

COMPLETING AN AUDIT ENGAGEMENT

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CHAPTER 7

COMPLETING AN AUDIT ENGAGEMENT

7.000 INTRODUCTION

7.001 Completing an audit engagement often is the most critical, yet most underestimated, phase of the audit in terms of the amount of time required and its importance to meeting the audit objectives. Good engagement "wrap-up" involves more than just the administrative tasks that first come to mind; it requires summarizing and evaluating audit findings, determining that the proper opinion and other reports are issued, performing a final review of the financial statements, and ensuring that the audit procedures and working papers conform with authoritative standards, as well as the firm's quality control policies and procedures.

7.002 The procedures involved in completing an audit should be performed before engagement personnel leave the client's offices, and should include:

- Performing final review analytical procedures.
- Obtaining legal letters.
- Reviewing for subsequent events.
- Summarizing and evaluating possible journal entries.
- Obtaining written management representations.
- Communicating to the entity:
  - reportable conditions.
  - errors and irregularities.
  - illegal acts.
  - certain other matters (if SAS No. 61 applies to the entity).
- Preparing financial statements and auditor's reports.
- Reviewing assistants' work.
- Consulting with others in resolving certain issues.
- Completing performance appraisals and final time summary.

7.003 These procedures and the applicable authoritative literature are discussed in the following sections.

7.100 ANALYTICAL PROCEDURES

7.101 As discussed in Chapter 2, analytical procedures are required to be performed in planning the nature, timing, and extent of auditing procedures. Chapter 3 discusses how analytical procedures are used as substantive tests to obtain evidential matter about particular assertions related to account balances and classes of transactions.

Change in 1995 Edition of the Tests of Balances Programs and the Analytical Procedures Program

Based on feedback we have received from users of these Manuals, we have revised the 1995 edition of the Tests of Balances Programs. Each Tests of Balances Program now includes the related substantive analytical procedures (previously included in the Analytical Procedures Program), which is designed to allow you to more easily choose the right mix of tests of details and substantive analytical procedures for each major audit area, based on the results of completing the Internal Controls Questionnaire, the Risk of Potential Misstatements Form, and the Tests of Controls Program, and considering which types of tests are the most efficient and effective for the audit area. Because of this change, the separate Analytical Procedures Program is no longer included in this Manual.

7.102 Statement on Auditing Standards (SAS) No. 56, *Analytical Procedures* (AU 329.04), also requires the use of analytical procedures "as an overall review of the financial information in the final review stage of the audit." Paragraph 22 of SAS No. 56 (AU 329.22) states:

> The objective of analytical procedures used in the overall review stage of the audit is to assist the auditor in assessing the conclusions reached and in the evaluation of the overall financial statement presentation.

7.103 Final review procedures should be based on reading the financial statements and notes and considering:

- Whether evidence gathered during the audit as to unusual or unexpected balances was adequate, and
- Whether there are any unusual or unexpected balances or relationships not identified during the audit.

The results of these procedures may require the auditor to perform additional tests.

7.104 Documentation of the overall review need not be elaborate. In fact, signing a program step indicating that the review was performed, with a conclusion as to the results of the review, may be sufficient. However, if the results of the overall review indicate that additional procedures must be performed, the authors recommend that such procedures be documented in a separate memo or working paper.

7.105 The review should be performed by someone familiar with all aspects of the engagement; generally they are performed by the in-charge. However, the engagement partner may be in a better position to provide a critical and objective review of the financial presentation.

7.106 The Engagement Performance Review Checklist in Chapter 12, section 12.411, contains a step that requires performance of the overall review.

7.200 OBTAINING LEGAL LETTERS

7.201 SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AU 337), provides guidance to the auditor in (1) identifying litigation, claims, and assessments, (2) determining that such matters are appropriately reflected in the financial statements, and (3) issuing the appropriate auditor's report.

7.202 The auditor's procedures for identifying litigation, claims, and assessments include:

- Inquiring of and discussing with management the policies and procedures for identifying, evaluating, and accounting for litigation, claims, and assessments.
- Obtaining from management a description and evaluation of litigation, claims, and assessments that existed at the balance-sheet date and up to the date the information is furnished (which should be the auditor's report date), including matters referred to legal counsel, and assurance from management that all matters required to be disclosed by SFAS No. 5, *Accounting for Contingencies*, have been disclosed.
- Examining the client's documents about litigation, claims, and assessments.
- Obtaining assurance from management that it has disclosed all unasserted claims that the lawyer has advised them are probable of assertion and must be disclosed in accordance with SFAS No. 5. This assurance is generally stated in the client's letter of inquiry to the lawyers.

7.203 A letter of inquiry to the client's legal counsel is the auditor's primary means of obtaining corroborating evidence of the information provided by management about litigation, claims, and assessments. This letter of inquiry and the lawyers' responses are so important that the client's refusal to send the letter or the lawyer's refusal to respond fully would be considered a limitation on the scope of the audit.

7.204 Letters should be sent to all lawyers with whom the client conducted business during the year under audit—a review of the client's correspondence with its lawyers, the lawyers' billings for services, and prior year's working papers are good sources of information for identifying the lawyers to whom letters of inquiry should be sent.

Practice Tip:

Generally accepted auditing standards requires the auditor to send a letter of inquiry if he or she has knowledge that an attorney has been consulted. If the auditor has no evidence of outstanding legal matters and the client has not consulted an attorney, and confirms such in the representation letter, the auditor is not required to confirm with the client's attorney the absence of litigation.

7.205 SAS No. 12 (AU 337.09) lists the following matters that should be covered in the letter of inquiry:

a. Identification of the entity and the date of the audit.

b. A list prepared by management (or a request that the lawyer prepare the list) that describes and evaluates pending or threatened litigation, claims, and assessments that the lawyer has been engaged to handle, and to which the lawyer has devoted substantial attention on behalf of the entity.

c. A list prepared by management that describes and evaluates unasserted claims and assessments that management considers to be probable of assertion and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome to which the lawyer has devoted substantial attention on behalf of the entity.

d. As to each matter in item b, a request that the lawyer either furnish the following or comment on matters as to which his or her views may differ from those stated by management:

   (1) A description of the nature of the matter, the progress of the case to date, and the action the entity intends to take.

   (2) An evaluation of the likelihood of an unfavorable outcome and an estimate, if possible, of the amount or range of potential loss.

   (3) With respect to a list prepared by management, an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.

e. As to each matter in item c, a request that the lawyer comment on those matters to which his or her views about the description or evaluation of the matter differ from those stated by management.

f. A statement by the client that the client understands that whenever, in the course of performing legal services regarding a matter recognized to involve an unasserted possible claim or assessment that may require financial statement disclosure, the lawyer has formed a professional conclusion that the client should disclose or consider disclosing the possible claim or assessment, the lawyer will so advise the client and will consult with the client about the disclosure and applicable requirements of SFAS No. 5.

g. A request that the lawyer confirm whether the understanding described in item f is correct.

h. A request that the lawyer specifically identify the nature of and reasons for any limitations on his or her response.

Other Considerations in the Letter

7.206 Immaterial Matters. To avoid requiring the lawyer to respond to clearly immaterial matters, many auditors will have the client include in the letter of inquiry an instruction that the lawyer need address only matters exceeding a specified dollar amount. This amount should be mutually agreed upon by the client and the auditor.

7.207 Timing of Letter and Response. Generally, letters of inquiry are sent at the beginning of year-end field work to give the lawyers adequate time to respond. Many auditors have the client specify the date of the lawyer's response, because AU Section 560, *Subsequent Events*, requires the auditor to inquire of the client's lawyer about litigation, claims, and assessments for the period from the balance-sheet date through the completion of field work. The specified date is generally slightly before the completion of field work to allow the auditor adequate time to evaluate the responses. As a practical matter, if the lawyer's response is dated more than two to three weeks before the completion of field work, the auditor should obtain an oral update directly from the lawyer. The results of this oral response should be documented.

7.208 Request for Unpaid and Unbilled Fees. To obtain information about unrecorded liabilities, many auditors have the client include a request that the lawyer indicate the amount of any unpaid or unbilled fees as of the balance-sheet date.

7.209 If the auditor becomes aware that the client's lawyers have resigned either during the year or subsequent to year end, the auditor should inquire as to the reasons for the resignation.

7.210 The in-charge and partner should carefully read and evaluate responses to determine that all significant litigation, claims, and assessments have been properly accounted for and disclosed, and to identify any limitations of the response, either expressly or by omission. Conclusions should be documented by the in-charge and reviewed by the partner. Illustrative inquiry letters to legal counsel are included in Chapter 13, sections 13.028 and 13.029.

7.300 SUBSEQUENT EVENTS

7.301 Completing the audit includes performing certain procedures to identify whether any events have occurred since the balance-sheet date that would require adjustment to or disclosure in the financial statements. AU Section 560 states:

> The independent auditor should perform other auditing procedures with respect to the period after the balance-sheet date for the purpose of ascertaining the occurrence of subsequent events that may require adjustment or disclosure essential to a fair presentation of the financial statements. . . . These procedures should be performed at or near the completion of the field work.

7.302 Procedures the auditor should perform to identify and evaluate subsequent events include:

- Read the latest available interim financial statements, compare them with the financial statements being reported upon, and make any other comparisons considered necessary. The auditor should determine whether the interim statements have been prepared on the same basis as that used for the audited financial statements.
- Inquire of and discuss with management having responsibility for financial and accounting matters as to:
  - The existence of any substantial contingent liabilities or commitments at the balance-sheet date or at the date of inquiry.
  - Any significant changes in long-term debt or working capital that have occurred up to the date of inquiry.
  - The current status of items that were accounted for on the basis of tentative, preliminary, or inconclusive data.
  - Any unusual adjustments made during the period from the balance-sheet date to the date of inquiry.
- Read the available minutes of meetings of the board of directors.
- Inquire of the entity's legal counsel concerning litigation, claims, and assessments.
- Obtain a representation letter from the client that includes a statement about whether any events have occurred subsequent to the balance-sheet date that, in the client's opinion, would require adjustment to or disclosure in the financial statements.
- Make any other inquiries or perform other procedures considered necessary.

7.303 To document performance of these procedures, the Subsequent Events Review Program is included in Chapter 12, section 12.304.

7.400 SUMMARY OF POSSIBLE JOURNAL ENTRIES

7.401 SAS No. 22, *Planning and Supervision* (AU 311), requires the consideration of an overall materiality limit during planning. SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU 312), requires the subsequent evaluation of misstatements by comparing the known, but unadjusted, and the estimated or projected misstatements, to the overall materiality limit. Auditors should think of materiality as a constantly evolving benchmark, rather than as a fixed amount calculated at the beginning of the engagement and carried through to its completion. Materiality thresholds should be revised as necessary in light of new information that arises during the course of the audit, and as the context in which it is used changes.

7.402 The summary of Possible Journal Entries Form in Chapter 10, section 10.302, is designed so that the auditor can subjectively consider whether the effects of possible journal entries are material to the financial statements as a whole.

7.403 The following types of misstatements should be included in the Summary of Possible Journal Entries Form:

- Known but unadjusted misstatements.
- Projected misstatements from sampling applications.
- Estimated misstatements from predictive analytical procedures.

Misstatements From the Prior Year

7.404 Often overlooked is the consideration of misstatements detected in the prior year that affect the current year. For example, assume last year's Summary of Possible Journal Entries Form included an item representing a $500 overstatement of prepaid insurance and an understatement of insurance expense. This item should also be posted to the current year's form because it affects the current year's insurance expense. Therefore, the prior year's Summary of Possible Journal Entries Form should be reviewed for any items that may have an effect on the current year's financial statements, and such items should be posted to the current year's form.

Establishing Thresholds for Posting Unadjusted Misstatements

7.405 Some firms establish a predetermined dollar threshold above which misstatements should be recorded as adjusting entries, and below which misstatements should be posted to the Summary of Possible Journal Entries Form as unadjusted misstatements. Often such a threshold results from the client's desire to record all misstatements detected during the audit that exceed a certain dollar amount. Other firms prefer to not establish such a threshold because they believe this decision should be based on the nature or sensitivity of the accounts affected by the misstatement.

7.406 To avoid posting clearly inconsequential misstatements, many firms also establish a threshold below which items are not to be posted to the Summary of Possible Journal Entries Form. In other words, they establish a minimum dollar amount that a misstatement must exceed to qualify for posting to the Summary. For example, if this minimum amount were $10.00, and a $9.00 misstatement is detected in cash, the misstatement would be noted in the cash workpapers, but not posted to the Summary of Possible Journal Entries Form. This process can often save valuable engagement time.

Using the Summary

7.407 The Summary of Possible Journal Entries Form should be prepared for all audit engagements by the in-charge and reviewed by the engagement partner.

> **Practice Tip:**
>
> Because professional judgment is needed to assess materiality and the effects that misstatements have on the financial statements, it is very important that the engagement partner participate in completing the Form. The partner therefore, should review each possible journal entry, as well as the final conclusion.

7.408 The overall materiality limit obtained from the Materiality Computation Form (Chapter 10, section 10.301) should be indicated in the space provided. Also, the dollar value over which misstatements should be posted to the Form should be indicated in the space provided.

7.409 The Summary of Possible Journal Entries Form has been designed to permit the evaluation of the effect of unrecorded misstatements on both the financial statements taken as a whole and on key components of the financial statements (i.e., current assets, noncurrent assets, etc.).

7.410 The Form is designed to permit easy evaluation of misstatements by key components of the financial statements, such as current and noncurrent assets, current and noncurrent liabilities, shareholders' equity, and the income statement. Misstatements should be posted to the Form in the appropriate columns (for Lotus 1-2-3 formulas, debits should be positive amounts and credits should be negative amounts).

7.411 Misstatements affecting the income statement are further broken down into three categories: known, estimated, and projected. "Known" misstatements are those for which the amount of the error is relatively certain. Such misstatements are often supported by highly reliable evidence, such as third-party documents. An example of a known misstatement would be a failure to record an invoice for repairs expense. Such an item would be posted to the Form as a debit (positive amount) in the "Known Misstatements" column and a credit (negative amount) in the "Current Liabilities" column.

7.412 As the term implies, "estimated" misstatements, are items for which the amount of the misstatement must be estimated. For example, if the auditor believes, based on prior collection history, that the client's reserve for bad debts is understated, the auditor would determine (with the client's assistance and input) the additional reserve needed, and would post this estimate to the Form as a debit (positive amount) in the "Estimated Misstatements" column and a credit (negative amount) in the "Current Liabilities" column.

7.413 "Projected" misstatements arise from projecting sampling errors to the sampling population (see the Audit Sampling Evaluation Form — Tests of Balances Sampling, section 10.507). For example, if a $1,000 accounts receivable misstatement is found in a sample of 10% of the population, the projected misstatement would be $10,000 (posted as a debit to the "Current Assets" column and a credit to the "Projected Misstatements" column). It is important to distinguish between the different types of income statement misstatements to aid in assessing the overall impact the unrecorded misstatements have on the financial statements. The "Total" column in the income statement section represents the sum of the known, estimated, and projected misstatements in the income statement columns.

7.414 After all possible journal entries have been posted to the Form and reviewed by the engagement partner, they should be discussed with the client. All entries subsequently recorded by the client should be removed from this Form and recorded on the trial balance so that only **unrecorded** entries remain on the Form. The columns for each key component should be totaled and then compared to the corresponding financial statement amounts. The total unrecorded income statement misstatements should be tax effected using the client's effective tax rate and compared to net income. The total unrecorded misstatements should be compared to the financial statement totals as a whole and by key component.

7.415 Concluding on the effect of misstatements on the financial statements is a matter of judgment and generally involves considering the nature of the misstatements (known, estimated or projected), overall materiality, and their impact on the financial statements taken as a whole. In instances when net income approaches zero, other factors may be considered, such as the effect of the misstatements on shareholders' equity, whether recording the adjustment to correct the misstatements would cause net income to become a loss, and historical earnings trends of the entity.

7.416 Adjustments would be proposed after considering the aggregate effects of all of the misstatements. If there are no known, projected, or estimated misstatements, this fact should be documented on the Summary of Possible Journal Entries Form.

7.500 CLIENT REPRESENTATIONS

7.501 The purpose of a client representation letter is to document oral and written representations made by the client to firm personnel during the course of the engagement, including representations made through the financial statements. While representations are not a substitute for applying necessary auditing procedures, they are considered an important part of the evidential matter an auditor must obtain. Management's refusal to sign the representation letter constitutes a scope limitation.

7.502 SAS No. 19, *Client Representations* (AU 333), establishes a requirement that the independent auditor obtain written representations from management on all audit engagements. It does not specify the form and content of a client representation letter; however, AU 333.04 provides a detailed listing of representations the auditor should consider obtaining. Those that apply to most engagements include:

- Management's acknowledgement of its responsibility for the fair presentation of the financial statements.
- Availability of all financial records and related data.
- Absence of errors in the financial statements and unrecorded transactions.
- Information about related-party transactions.
- Noncompliance with aspects of contractual agreements that may affect the financial statements.
- Information about subsequent events.
- Irregularities involving management or employees.
- Plans or intentions that may affect the carrying value or classification of assets or liabilities.
- Disclosure of compensating balance or other arrangements involving restrictions on cash balances, and disclosure of lines-of-credit or similar arrangements.

- Satisfactory title to assets, liens on assets, and assets pledged as collateral.
- Agreements to repurchase assets previously sold.
- Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.
- Other liabilities and gain or loss contingencies that are required to be accrued or disclosed by SFAS No. 5.

7.503 SAS No. 19 states if management refuses to furnish written representations, the auditor should consider the effect of this refusal on his or her ability to rely on other representations. In such situations, the auditor would issue a qualified or disclaimer of opinion due to a scope limitation. The authors believe that, in most cases, auditors should disclaim an opinion, because management's refusal to sign the representation letter indicates that all other written and oral representations made during the audit cannot be relied on.

7.504 The client representation letter should be dated as of the date of the auditor's report and signed by at least the chief financial officer of the entity. A sample client representation letter is shown in Chapter 13, section 13.032. This letter should be tailored to fit the circumstances of each engagement.

7.600 REQUIRED COMMUNICATIONS

Overview

7.601 Several SASs require that certain matters be communicated to clients and/or to the entity's audit committee. The following is a summary of these requirements for audits conducted in accordance with generally accepted auditing standards (GAAS):

- SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit* (AU 325), requires that auditors communicate deficiencies in the design and operation of the entity's control structure (referred to as "reportable conditions").
- SAS No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities* (AU 316), and SAS No. 54, *Illegal Acts by Clients* (AU 317), require auditors to report any irregularities and illegal acts (unless they are clearly inconsequential) the auditor becomes aware of during the course of the audit.
- SAS No. 61, *Communications with Audit Committees* (AU 380), for certain entities, specifies audit-related matters that auditors should communicate to the audit committee.

7.602 SAS No. 61 applies to entities that have an audit committee, or that has formally designated oversight of the financial reporting process to a group equivalent to an audit committee, such as a finance or budget committee. If the entity does **not** have an audit committee or a formally designated group that oversees the financial reporting process, auditors may choose to communicate the matters discussed in SAS No. 61 if they believe management or members of the board would benefit from the communication. Section 7.618 discusses the matters that may be communicated.

7.603 Persons to Whom Communications Should be Directed. Communications under the four SASs listed above should be directed to the audit committee, or if there is no audit committee, to the individuals with equivalent authority, such as the board of directors. As mentioned above, the SAS No. 61 communication is not required if there is no formally designated group responsible for overseeing the financial reporting process; however, communications of internal control structure related matters and irregularities and illegal acts is required even if the entity does not have an audit committee.

7.604 Must the Communications be in Writing? The communications required under SAS Nos. 53, 54, 60, and 61 may be either oral or written. Oral communications should be documented in the working papers. Written communications should indicate that they are solely for the use of the board of directors, audit committee, or, if appropriate, management.

7.605 The required communications are generally made at the end of the audit. However, if the matter is significant or requires immediate corrective action, the auditor may want to communicate the matter before the end of the audit. The Engagement Performance Review Checklist in Chapter 12, section 12.411, contains a step to remind engagement personnel that these communications must be made. The Internal Control Structure Reportable Conditions Form in section 10.801 should be used throughout the engagement to note all reportable conditions as well as any client operational or administrative inefficiencies. (See discussion on reportable conditions in sections 7.606–7.613.)

Internal Control Structure Related Matters (Reportable Conditions)

7.606 As mentioned in section 7.601, as a part of an audit in accordance with GAAS, an auditor must communicate to the client reportable conditions noted in an audit. Paragraph 2 of SAS No. 60 explains that reportable conditions:

> . . . are matters coming to the auditor's attention that, in his judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of the internal control structure, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Such deficiencies may involve aspects of internal control structure elements of (a) the control environment, (b) the accounting system, or (c) control procedures.

7.607 SAS No. 60 establishes two categories of reportable conditions: (1) deficiencies in the design of the internal control structure, and (2) deficiencies in the operation of the internal control structure. Design deficiencies relate to inadequate or absent control structure policies and procedures that could adversely affect the entity's ability to record and report financial information. For example, a design deficiency could exist in an entity if it does not have policies and procedures that require that two persons open mail receipts of cash. A deficiency in the operation of the control structure occurs when the entity has designed appropriate control policies and procedures, but they are not being followed or they are ineffective. Using the example above, an operational deficiency would occur if the entity's policies and procedures require that two persons open mail receipts, but in fact only one person does so.

7.608 Material Weaknesses. Some reportable conditions may be of such a magnitude that a material error or irregularity could occur and not be detected timely by employees in performing their normal assigned functions. These reportable conditions are considered material weaknesses. Many auditors separately identify material weaknesses from other reportable conditions in their written communications, either because the client asks them to do so or because they want to emphasize the conditions; however SAS No. 60 does not require that an auditor separately identify material weaknesses in the report on reportable conditions.

7.609 Operations and Management-Related Matters. SAS No. 60 also recognizes that an auditor may identify other matters during the course of the audit that would benefit management or the audit committee that are not reportable conditions. For example, the auditor may want to communicate to management suggestions for improving operational and administrative efficiencies. In communications that contain both reportable conditions and other matters, each should be clearly identified.

7.610 Reporting Requirements. The report on reportable conditions should:

- Indicate that the purpose of the audit was to report on the financial statements and not to provide assurance on the internal control structure.
- Include the definition of reportable conditions.
- Include the restriction on distribution that states that the communication is intended solely for the information and use of the audit committee, management, and others within the organization.

SAS No. 60, par. 17 (AU 325.17) states that a written communication indicating that no reportable conditions were noted during the audit should *not* be issued.

7.611 The following is a sample report on reportable conditions based on the guidance in SAS No. 60 (AU 325.12):

> In planning and performing our audit of the financial statements of the ABC Company for the year ended December 31, 19XX, we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurances on the internal control structure. However, we noted certain matters involving the internal control structure and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control structure that, in our judgment, could adversely affect the company's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.
>
> (Describe the reportable conditions noted.)
>
> This report is intended solely for the information and use of the audit committee, management, and others within the Company (or specified regulatory agency or other specified third party).

A sample report on reportable conditions is shown in Chapter 13 at section 13.036.

7.612 When no material weaknesses are included with reportable conditions, the auditor may use the following format for a written communication:

> (Include the first paragraph of the report illustrated in section 7.611.)
>
> (Describe the reportable conditions noted.)
>
> A material weakness is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.
>
> Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses as defined above. However, none of the reportable conditions described above is believed to be a material weakness.
>
> (Include the final paragraph from section 7.611 above.)

A sample report on reportable conditions that also identifies material weaknesses is shown at section 13.037.

7.613 The Internal Control Structure Reportable Conditions Form included in Chapter 10, section 10.801, is provided to accumulate the reportable conditions identified during the course of an audit. The Engagement Performance Review Checklist in Chapter 12, section 12.411, contains a reminder to perform this communication before the engagement is completed.

Errors, Irregularities, and Illegal Acts

7.614 Audit planning involves assessing the risk that errors, irregularities, and illegal acts having a direct effect on financial statement amounts may occur and cause the financial statements to contain a material misstatement. The auditor is responsible for assessing this risk and designing appropriate auditing procedures to reduce this risk to an acceptable level.

7.615 Communication of Irregularities and Illegal Acts. SAS Nos. 53 and 54 require the auditor to ensure that the entity's audit committee, or others of equivalent authority, is adequately informed of any irregularities and illegal acts having direct and indirect effects on the financial statements, unless they are clearly inconsequential. With respect to illegal acts, the communication should describe the act, the circumstances of its occurrence, and its effect on the financial statements.

7.616 Communication of Errors. SAS No. 53 does not specifically require that errors be communicated; however, if the entity is subject to SAS No. 61 (that is, it has an audit committee or other formally designated group responsible for oversight of the financial reporting process), then the auditor must communicate information about errors in the financial statements. See section 7.618 for a discussion of the communication requirements under SAS No. 61.

7.617 The Engagement Performance Review Checklist in section 12.411, contains a step to remind the auditor of the requirements to communicate irregularities and illegal acts.

Other Matters

7.618 SAS No. 61 requires the auditor to communicate certain matters about the scope and results of the audit that may assist the audit committee in overseeing the financial reporting and disclosure process. As mentioned in section 7.602, this communication is required only for entities that have an audit committee or a formally designated group responsible for the oversight of the financial reporting process; however, auditors of entities that do not have such groups may find such communications beneficial. SAS No. 61 (AU 380.06–.14) requires communication of the following matters:

- The level of responsibility assumed by the auditor in an audit performed in accordance with GAAS in regards to matters of interest to an audit committee, such as the internal control structure and whether the financial statements are free of material misstatement.
- The initial selection of and changes in significant accounting policies or their application, including methods used to account for significant unusual transactions and the effect of significant accounting policies in controversial or emerging areas for which there is no authoritative guidance or consensus.
- The process used by management in formulating particularly sensitive accounting estimates and the basis for the auditor's conclusions about the reasonableness of those estimates.
- Adjustments arising from the audit that could, in the auditor's judgment, either individually or in the aggregate, have a significant effect on the entity's financial reporting process.
- The auditor's responsibility for other information in documents containing audited financial statements, any procedures performed, and the results.
- Disagreements with management, whether or not satisfactorily resolved, if they relate to matters that individually or in the aggregate could be significant to the entity's financial statements or the auditor's report. These disagreements may relate to:
  - — the application of accounting principles to specific transactions and events,
  - — the basis for management's judgments about accounting estimates,
  - — the scope of the audit or the wording of the auditor's report, or
  - — disclosures to be included in the entity's financial statements.
- The auditor's views about matters that were the subject of management's consultation with other accountants about auditing and accounting matters.
- Any major issues discussed with management in connection with the initial or recurring retention of the auditor including, any discussion about the application of accounting principles and auditing standards.
- Any serious difficulties encountered in dealing with management during the audit, such as unreasonable delays by management in permitting the commencement of the audit or in providing needed information, the unavailability of client personnel, or the failure of client personnel to complete client-prepared schedules on a timely basis.

7.619 The Engagement Performance Review Checklist in Chapter 12, section 12.411 contains a step to remind the auditor of this required communication.

7.700 ADMINISTRATIVE WRAP-UP OF ENGAGEMENTS

7.701 The administrative wrap-up of engagements should include the following functions as applicable:

1. Schedule and complete all levels of review.
2. Obtain all signed correspondence.
3. Furnish client with copies and obtain approval of final adjustments.
4. Clear and dispose of all review and "to do" points.
5. Prepare working paper for things to do and time savings for next year.
6. Communicate reportable conditions and other matters.
7. Monitor processing and delivery of report and tax returns.

Scheduling and Completing Reviews

7.702 Timely completion of the review function can make a major contribution to engagement profitability. All reviews, including the tax accrual/provision review, engagement performance and report review, independent technical review and engagement partner review, as applicable, should be planned and scheduled in advance by the in-charge. The reviewers should be informed early if scheduled dates are changed. For maximum efficiency, review functions should be performed in the field wherever possible. In this way, the reviewer can avoid the usual telephone and office interruptions, can resolve problems while staff is still working on the engagement, and can use the opportunity to visit and observe the client's personnel and operations. The in-charge should carefully plan and assign staff's work responsibilities to coordinate with the field reviews for timely and efficient completion of the engagement.

Obtaining Signed Correspondence

7.703 The Correspondence Control Form in Chapter 14, section 14.003, should be used by the in-charge to monitor the receipt of required correspondence. The engagement partner should determine that all correspondence has been received before signing and releasing the report.

Furnishing Client With Adjustments

7.704 The in-charge is responsible for furnishing the client with copies of all adjustments and reclassifications. All adjusting entries must be approved and posted to the client's records as of the balance-sheet date. It is not necessary for the client to post our reclassification entries.

Review and "To Do" Lists

7.705 Lists of review and "to do" points are temporary records of possible additional work necessary to complete an engagement. The results of any additional procedures performed should, of course, be documented in the working papers. Any review or "to do" points that pertain to future engagements should be summarized and included in the Time Budget and Control File for next year's follow-up. All lists of review and "to do" points should be destroyed after engagement completion..

Report and Tax Returns Issuance

7.706 The in-charge is responsible for monitoring the engagement completion and communicating with the partner. Typing and processing delays should be resolved by the partner and any changes of promised dates should be communicated to the client promptly. All reports and tax returns should be delivered to the client timely.

Supervision and Review

CHAPTER 8

SUPERVISION AND REVIEW

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CHAPTER 8

SUPERVISION AND REVIEW

8.000 INTRODUCTION

8.001 Effective supervision, one of the nine elements of a system of quality control for CPA firms outlined in the Statement of Quality Control Standards (SQCS) No. 1, *Statement of Quality Control for a CPA Firm*, is an essential element of quality, efficient engagements. This Statement requires firms to establish policies and procedures for conducting and supervising work at all organizational levels to provide reasonable assurance that the work performed meets professional standards. The sample quality control policies and procedures found in QC 90.16 provide the following three basic objectives for designing a quality control system for supervision:

- Provide procedures for planning engagements.
- Provide procedures for maintaining the firm's standards of quality for the work performed.
- Provide procedures for reviewing engagement working papers and reports.

8.002 Each firm should design quality control policies and procedures for supervision and review that fit its unique organizational and operating characteristics.

8.003 The requirement to supervise engagement personnel is also found in SAS No. 22, *Planning and Supervision* (AU 311.13), which states:

> The work performed by each assistant should be reviewed to determine whether it was adequately performed and to evaluate whether the results are consistent with the conclusions to be presented in the auditor's report.

8.004 Proper supervision should include, among others things, the following:

- Helping assistants design procedures to resolve engagement problems early.
- Making sure assistants thoroughly understand the objectives and procedures of an assignment before beginning.
- Helping assistants prioritize, organize, and control the approach to assigned work areas.
- Periodically checking on the assistants' progress.
- Keeping assistants informed of other engagement matters affecting the assigned work area.
- Rotating work assignments and offering assistants opportunities to work in new areas.

- Motivating assistants to maximum performance levels.
- Supervising paraprofessionals and temporary help.
- Appraising staff performance.

8.100 REVIEW OF WORKING PAPERS

8.101 The firm's quality control system for supervision should address procedures for reviewing working papers, including who performs these reviews and how the reviews are documented. In most firms the in-charge performs a detailed review of the work of all assistants to determine that sufficient evidence has been gathered to accomplish the engagement objectives and that the engagement procedures and documentation are in accordance with the firm's quality control standards. Also, the in-charge initials and dates each working paper to indicate that he or she is satisfied with the work performed.

8.102 The engagement partner is responsible for reviewing work performed by the in-charge and the results of the in-charge's review of assistants' working papers. The objectives of his or her review is to determine that sufficient evidence has been gathered to accomplish engagement objectives and that the engagement procedures and documentation are in accordance with the firm's quality control standards. The engagement partner generally reviews all of the working papers, and documents this review by initialling and dating each working paper.

8.103 The engagement partner's review also should determine that all firm quality control standards have been met. Depending on the complexity of the engagement, and the experience of staff, the partner may review all engagement working papers, or may choose to review only the working papers supporting material or unusual audit areas. The checklists reviewed should be signed in the space provided for the partner or initialed under the engagement partner's signature.

The In-charge Review

8.104 The in-charge's detailed review of assistant's work should be performed as frequently as possible, as each audit area is completed. Immediate feedback is often difficult to give under the time constraints of an audit, but is essential to providing effective on-the-job training. The in-charge's review procedures should include at least the following:

- Review the applicable section of last year's working papers.
- Review the applicable section of the work program.
- Compare current and prior period trial balance accounts related to the work area and note variations.
- Briefly review the contents of the working papers.
- Read the conclusions.
- Review the working papers in detail for:
  - — Mathematical accuracy.

- — Accomplishment of the purposes of the documentation, such as engagement objectives.
- — Proper performance of procedures.
- — Reasonableness of judgments.
- — Identification and follow-up of exceptions.
- — Resolution of problems and questions.
- — Projection of sample results to the population

- Determine that all work program procedures have been completed correctly.

The Partner Review

8.105 The partner should review the work of engagement personnel as frequently as practical. The partner's review should be conducted in the field whenever possible. Field reviews allow problem resolution while staff is working on the engagement, prevent typical office interruptions, enable the partner to schedule review time, and allow the partner to be seen by client personnel.

8.106 The engagement partner's review may, as previously mentioned, be conducted in greater or lesser detail depending on the complexity and size of the engagement and on the experience of engagement personnel. Except for periodic discussions with engagement personnel, the partner's review normally will occur during the final stages of the engagement.

8.107 Completion of the Engagement Performance Review Checklist included in Chapter 12, section 12.411 documents that the in-charge and engagement partner are satisfied that engagement personnel have been properly supervised and the work performed has been properly reviewed.

8.200 PREPARING FINANCIAL STATEMENTS AND AUDITOR'S REPORTS

8.201 Volume 4 of this Manual contains guidance for the in-charge when drafting financial statements, notes, and reports. It also contains a disclosure and reporting checklist that should be completed on all engagements. Completion of the Engagement Performance Review Checklist in section 12.411 documents the engagement partner's approval that the financial statements and auditor's reports conform with authoritative and professional standards.

8.300 CONSULTATION ON ENGAGEMENTS

8.301 An important part of ensuring that firms provide high-quality engagements is encouraging staff to seek assistance when needed from the appropriate individuals. They should also be advised of the individuals within or outside the firm designated as specialists in various industries and special situations.

8.302 SQCS No. 1 (QC 10.07) states:

> Policies and procedures for consultation should be established to provide the firm with reasonable assurance that personnel will seek assistance, to the extent required, from persons having appropriate levels of knowledge, competence, judgment, and authority. The nature of the arrangements for consultation will depend on a number of factors, including the size of the firm and the level of knowledge, competence, and judgment possessed by the persons performing the work.

8.303 All firms that are members of the AICPA are obligated to follow the quality control standards. As a result, every firm should establish and maintain a quality control system appropriate for its particular operational and organizational structure.

8.304 The following are three basic objectives (found in QC 90.14) for consultation that a firm should consider in developing its policies and procedures:

1. Identify areas and specialized situations where consultation is required, and encourage personnel to consult with or use authoritative sources on other complex or unusual matters.

2. Designate individuals as specialists to serve as authoritative sources, and define their authority in consultative situations. Provide procedures for resolving differences of opinion between engagement personnel and specialists.

3. Specify the extent of documentation to be provided for the results of consultation in those areas and specialized situations where consultation is required. Specify documentation, as appropriate, for other consultations.

8.305 Each firm should carefully design quality control policies and procedures over consultation that fit its unique operating and organizational characteristics. These policies and procedures should be communicated to all professional staff, preferably in a written quality control document, so that they are aware of the situations that require consultation and of the individuals from whom they should seek advice or assistance.

8.306 Examples of situations that may require consultation include:

- Going-concern problems.
- Identification of errors, irregularities, and illegal acts.
- Information that raises doubt about management's integrity.
- Unresolved disagreements among engagement personnel.

8.307 All consultations should be documented in a memorandum to the working papers that includes a description of the issue, relevant authoritative literature, and the resolution. The memo should be signed by the individual who prepared the memo, the consultant or specialist, and the engagement partner. See Chapter 10, section 10.800 for a sample consultation form.

8.400 PERFORMANCE APPRAISALS

8.401 Performance appraisals should be completed by the in-charge for all staff working on an engagement. Similarly, the engagement partner should perform an appraisal for the in-charge. To achieve maximum benefits from these feedback mechanisms, appraisal forms should be prepared and reviewed with the staff immediately after the engagement's completion.

8.500 FINAL TIME SUMMARIZATION

8.501 The in-charge is responsible for the final time summarization, its reconciliation to client time charges in the firm's billing records, and its final comparison to budget. Reasons for budget overruns should be documented. Suggestions for next year's possible time savings should also be included. These documents should be discussed with the engagement partner prior to preparing the final client billing. Finally, a tentative budget should be prepared for next year's engagement. Chapter 11 includes budget and time control forms to collect the engagement staff's time and suggestions for modifying procedures on the next year's engagement.

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